RESEARCH HANDBOOK ON THE

History of Corporate and Company Law

Edited by

Harwell Wells

RESEARCH HANDBOOKS IN CORPORATE LAW AND GOVERNANCE

Series Editor: **Randall S. Thomas**

RESEARCH HANDBOOK ON THE HISTORY OF CORPORATE AND COMPANY LAW

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Series Editor: Randall S. Thomas, *John S. Beasley II Professor of Law and Business, Vanderbilt University Law School, USA*

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Introduction

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The chapters in this *Handbook* survey the growth of corporate and, more generally, business organization law from the Medieval era to the present day, addressing developments over time in jurisdictions around the globe. Their authors have taken a range of approaches—some focusing on the evolution of business organizations in a particular nation across a fixed span of time, others providing more fine-grained accounts of the developments of particular business forms or legal-intellectual trends within a nation and period, with still others broadening their scope to ask about developments across national borders and geographic regions. The audience for these chapters will be, this writer hopes, similarly varied; there is much here that should interest legal scholars, historians, and economists, and perhaps especially those working along the fertile borderlands of these fields. What any individual scholar will take away will, of course, depend on her individual interest; what will catch the eye of a business historian of a particular nation may well differ from what will interest a student of comparative law. It is even to be hoped that some of these chapters will speak to scholars far removed from business, economic, and legal history. To give a few examples, historians of modern European politics might be surprised to learn how fascist ideology impacted the corporate law of Germany, Italy, or Spain; students of religion may be interested in the account of how complex power relationships in traditional Islamic regimes hindered the growth of the corporate form; and theorists of the modern corporation will be intrigued to see how notions of corporate personhood took form in a Chinese legal culture steeped in Confucian beliefs, or how features of the modern corporation can be discerned in an organizational form that flourished in India in the first millennium C.E.

The overwhelming importance of giant corporations in modern economics, politics, and culture alone justifies historical study of their legal development. Because, however, this volume appears in Edward Elgar's series of *Research Handbooks in Corporate Law and Governance*, it is worthwhile pointing particularly to a few recent, major, and occasionally overlapping controversies in corporate law and governance to which

some (or all) of the chapters here, and the historical approach they take, can contribute.

Many of the chapters can be profitably read in conjunction with Kraakman et al's *Anatomy of Corporate Law*, in which an international team of corporate law scholars identify five basic legal characteristics they argue are today shared by business corporations across jurisdictions, characteristics necessary for the operation of large modern business enterprises: legal personality; limited liability; transferable shares; delegated management under a board structure; and investor ownership (Kraakman et al 2017). While this team of authors does not doubt that corporate law is not completely uniform, and takes no position in their book on whether the law is converging on a single model, its work still offers a model of present-day corporate law that emphasizes core elements shared across borders. Whether this is correct, and if so how business forms in different jurisdictions came to share these core elements, are questions whose answers can be quarried from materials presented here. So, too, one can inquire which legal characteristics (if any) were necessary, or most significant, to the development of the corporation—and whether the answer to that question changed over time. Once, limited liability for shareholders was widely heralded as the great innovation of corporate law. A century ago Nicholas Murray Butler famously identified the "limited liability corporation as the greatest single discovery of modern times" (Micklethwaite and Wooldridge 2003: xxi). Yet many have observed that shareholders in pre-20th century corporations did not always have limited liability. More recently, scholars have identified the ability of the corporate legal form to lock in financial capital (Blair 2003), or the ability of the corporation and other business organizations to shield their assets from their owners' creditors (Hansmann and Kraakman 2000), as their essential or indispensable feature.

In a related scholarly debate, a number of the chapters here can also profitably contribute to debates over the trajectory of corporate law—specifically, whether there has been over the past century convergence between different nations' corporation laws such that it makes sense to speak of a trend towards "a single, standard model" of corporation law marked by both the structural elements mentioned above and by a shared ideological commitment to "the view that corporate law should principally strive to increase long-term shareholder value" (Hansmann and Kraakman 2000: 439). The argument that corporate law is converging has drawn acclaim, but also critics, who contend that emphasis on convergence ignores path dependence and the way peculiarities of national history and political economy will continue to shape jurisdictions' corporate laws (Cabrelli and Siems 2015).

Some of the contributions here also move beyond a narrow focus on the corporation to shed light on the development of other organizational forms. Recent years have seen calls for greater attention to be paid to business forms that are *not* corporations. While the corporation has traditionally received most scholarly attention, in 2007 Guinnane et al. forcefully challenged "the idea that the spread of the corporate form of organization was a decisive factor in modern economic growth." Their work pointed out that the corporate form carried drawbacks as well as advantages, and that more attention and study should be given to the development and spread of the more flexible private limited liability company (PLLC), a form better suited to small- and medium-sized enterprise (Guinnane et al. 2007). Several chapters here take up that challenge.

Finally, some chapters specifically address the contentious debate over "legal origins." In a series of articles beginning in 1997, Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny, ("LLSV") argued that different nations' laws could usefully be categorized into legal families based on their historical origins; that legal rules protecting shareholders varied systematically among legal families; and that the laws of nations rooted in the common law not only better protected investors than those of civil-law nations—notably those of the French civil-law family—but consequentially produced better economic outcomes in several areas (La Porta et al. 1997; La Porta et al. 1998; La Porta et al. 2008). The claims of "LLSV" provoked a large literature in which their methods and conclusions were heralded, challenged, or dismissed (Spamann 2010). Several chapters here touch on these debates, particularly on the question of whether civil law legal systems have historically proven less flexible and less shareholder protective than common law systems.

OVERVIEW

Part I: Taking Shape

The volume opens with an account that provides a nice counterpoint to subsequent works here. *Jared Rubin*, in "Islamic Law and Economic Development," examines how a polity evolved without anything resembling a corporation law. In the Islamic world, he explains, corporations did not develop until the mid-19th century, even though it was economically far ahead of Europe for centuries. Taking the Ottoman Empire as a case study, Rubin attributes this to a dampening effect of Islamic

law—being careful, however, to note that his argument is not that "Islam is incapable of change or it is some inherent Islamic conservatism that is at fault." Rather, he argues, in Islamic polities rulers' legitimacy rested heavily on the clerical establishment, and resulted in large areas of law being ceded to that establishment—including commercial law. Yet, while Islamic law provided for partnerships, those partnerships were dissolved on a partner's death, and inheritance law provided for distribution of the partner's assets to heirs by a fixed formula. These inflexible rules hindered the growth of large-scale partnerships similar to those that, in Europe, slowly led to joint-stock companies and then corporations. In sum, the power arrangement that left commercial law to the clerical establishment ultimately blocked the development of corporations as well as other commercial arrangements that, in Europe, helped spur economic growth.

We then turn to a form of business organization that flourished long before the dawn of the modern era. *Vikramaditya Khanna*'s chapter examines business organizations in India before the arrival of the British East India Company, focusing on the *sreni*, an organizational entity primarily engaged in business and commerce that flourished in the subcontinent for almost two millennia (800 BCE to 1000 CE). Study of the *sreni* is warranted not only because of its use across a long and understudied span of history, but because its development sheds light on factors identified as relevant to the development of European business organizations, such as increasing trade, the need to contain agency costs, and methods to engage in asset partitioning and entity shielding. The history of the *sreni* shows sophisticated attempts to address agency costs and incentive effects, as well as considerable agility in adapting to changing business conditions. And, Khanna shows, while the *sreni* faded after 1000 CE, it had lasting effects on business in the subcontinent and may have impacted Mughal institutions in ways that had important repercussions for later economic growth.

We begin to follow the development of modern organizational forms with *Yadira González de Lara's* chapter on business organization and organizational innovation in late Medieval Italy. It examines three organizational innovations defined by contract and law: first, the variety of credit instruments, from short-term loans to exchange contracts, available to Medieval merchants; then the *commenda* contract, a form of commercial association that enabled both representation abroad and pooling of capital; and finally, the development of the *compagnia* as a modern partnership form. The chapter draws on modern economic and legal theory to argue that these developments helped set European merchants on a distinctive path of economic development that arguably explains the

later economic success of the Latin West. The tale told here is not merely historical, but shows business people in the past addressing problems still central to organizational analysis, as they sought to devise mechanisms to address moral hazard and incomplete contracting, to lock in capital, and to shield their enterprises' assets from both the owners' creditors and the state.

In his chapter, *Ron Harris* follows the transformation of the corporate form from an entity chiefly for municipal and public purposes, developed in the Medieval period, to one used for business and trade. At the center of his account are the formations at the turn of the 17th century of the English East India Company ("EIC") and the Dutch East India Company (Verenigde Oostindische Compagnie, "VOC")—the first publicly held business corporations and the templates for later adopters of this organizational form. In these two firms the preexisting legal institution of the corporation was put to new use, as the framers of the EIC and VOC borrowed and modified the corporate form, and married it to financial innovations related to joint-stock, to enable successful collaboration between entrepreneurs pursuing oceanic trade with Asia and investors seeking to protect their interests vis-à-vis insiders. The resulting institution met diverse needs, serving as a platform for long-term enterprise, enabling impersonal investment by a large number of investors, mitigating informational asymmetries, and spreading the high risks of oceanic trade.

Part II: Modern Europe

We then turn to the development of modern corporation and company law, beginning with Europe. In his chapter, *John D. Turner* charts the growth of English company law from the 15th through the 19th centuries, showing how company law only slowly came to offer businesses all five of the characteristics generally identified as marking the modern company or corporation: separate legal personality; limited liability; transferable joint-stock; delegated management; and investor ownership. In this account, it is particularly notable that England went through its Industrial Revolution without freedom of incorporation and with a legal framework which actually restricted the development of business corporations. While at moments English law and politics were amenable to the corporate form, for much of the 18th and even into the 19th century statutory and common law were inhospitable to widespread incorporation, only changing in the 19th century when the rising political power of the middle classes ultimately pushed Parliament to liberalize incorporation law. *Contra* some arguments that the common law is inherently flexible and responsive to

new business opportunities, this is an account in which the common law did not facilitate growth, and in which easy access to incorporation only followed political agitation and legislative intervention.

Picking up with UK company law at the beginning of the 20th century, *Marc T. Moore* focuses more tightly on a particular aspect of UK company law, the widely accepted generalization that, in contrast to many other jurisdictions, UK company law has always given shareholders primacy. While not disagreeing with this generalization—indeed, Moore shows the collection of legal rules and principles that tend to establish it today—he argues that this primacy has been more contested than is recognized. Across the 20th century there has been a good deal of "doctrinal and ideological turbulence" in UK company law concerning who the corporation should chiefly serve. In the 1970s the UK even came close to adopting an "industrial democracy" approach which would have provided for employees' representation on large companies' boards—an approach thwarted, in part, by labor's belief that it was better protected outside the corporate governance mechanism. Thus, while present UK law may embody a shareholder primacy stance, that stance has not always fitted with the nation's broader social and political currents, and could still prove vulnerable to the consequences of economic and demographic changes.

Two chapters discuss corporation and company law in Germany. *Timothy W. Guinnane* provides an account of German company law, 1794–1897, showing both the slow adoption of German law to the corporation—a process similar to that in other countries—and, more unusually, the development of other business forms as well. To speak of "German" law is something of a misnomer for much of the century, as the German Empire only came into existence in 1871, and before (and sometimes after) then company law could vary significantly from state to state. Much of corporate law's development in this era turned on whether would-be incorporators had to seek specific permission from the state to incorporate, and the law developed from a system in which the state granted a firm a specific charter and accompanying privileges (*Oktroi*), to a concession system in which the state issued charters in a more standardized, regularized process, as adopted in Prussia's 1843 Corporations Act, to a liberalized, general incorporation system in which any group of entrepreneurs could have access to incorporation (1870 Corporations Act). This chapter also provides an account of business forms other than the corporation, notably the Cooperative, which played an unusually important role in the German economy, and the GmbH, a hybrid business form established near the end of the 19th century that would become widespread in the 20th.

German corporate law in the 20th century is the topic of *Thilo Kuntz's* chapter. Kuntz places the development of the law firmly in the context of Germany's tempestuous history, with turning points in the law deeply inflected by politics. The chapter focuses on the *Aktiengesellschaft*—the large corporation—which entered the 20th century with its distinctive requirement for both an executive board (now *Vorstand*) and supervisory board (*Aufsichtsrat*) already established and with shareholder power—at least in theory—paramount. In 1937, however, the confluence of long-standing attempts at corporate-law reform and Nazi ideology led to a new orientation for German corporation law, with reduced shareholder rights and a sharp separation between executive and supervisory board. The account then moves on to the postwar era, where codetermination, whose roots can be traced back to the 19th century, was adopted in stages, beginning in 1951, giving workers and shareholders equal representation on the supervisory board, initially in the mining, iron, and steel industries but later widening to all *Aktiengesellachaft* above a certain size. With this the essential structural features of present-day German corporate law were in place.

Jean Rochat's contribution surveys the development of the corporation in France—the *société anonyme* ("SA")—from its initial appearance in the *Code de Commerce* of 1807 to the Act of 1867 that allowed it to be formed by simple registration. While earlier accounts have presented the appearance of the SA as a radical departure from previous business models, this chapter argues that the SA as developed in 1807 was a continuance of the older form of chartered company, a form used since the 17th century. It was between 1807 and the 1860s—while the law remained static—that the SA as an institution gradually changed from an organization chiefly intended for a limited range of activities and imbued with a public purpose, to an organizational form utilized by the businesses typical of large-scale capitalism, notably railroads. Significant legal changes in 1863 and 1867, in this telling, were largely intended to recognize in legislation the social and case-law developments that had occurred over the previous half-century. This chapter not only revises our understanding of French corporate development in the 19th century, replacing an account of radical discontinuities with one of gradual change, it also suggests that the sharp division made by some between rigid civil law, fixed in statutes, and flexible common law, developed in cases, is overblown.

In their contribution, *Marco Ventoruzzo* and *Giulio Sandrelli* examine the evolution of modern Italian corporate law by focusing on share classes and voting rights. From a variegated voting and class system in the 19th century, the authors show convergence during the late 19th and

early 20th century towards a one-share, one-vote norm, followed later in the century by a countercurrent marked by increased flexibility in voting arrangements and eventual elimination of a ban on multiple voting shares. Along the way the authors demonstrate that these developments were not only produced by internal dynamics of corporation law but by larger national and international developments—"competition among European jurisdictions, circulation of legal models internationally, … a growing faith in market efficiency and [in] the ability of contractual freedom to adopt the most efficient solution."

The development of corporation law in Spain is the subject of *Susana Martínez-Rodríguez's* chapter. In some ways, Spanish law was notably conducive to corporations. In 1829 Spain adopted a corporation law allowing any man to register a corporation, a departure from the rules of most other European nations which at that time required incorporators to seek special governmental approval. While this right of general incorporation was suspended in 1848, it was again made available in 1869. When Spain adopted a new Commercial Code in 1885, it was surprisingly favorable to corporations, as its relative lack of detailed requirements gave corporate organizers great flexibility to arrange the internal affairs of their firms as they saw fit. This relative flexibility continued through much the 20th century, extending to the limited liability company (*Sociedad de Responsabilidad Limitada*, or SRL), which was legalized in 1919. While Spain's company law was updated occasionally throughout the century, significant change came again at century's end when Spain's entry into the European Economic Community (EEC) required legislative reforms to bring its law in line with European directives.

Concluding this section, *Martin Gelter's* chapter examines European (EEC, EC, and EU) efforts to harmonize European company law since the establishment of the European Economic Community. He identifies two distinct periods in which harmonization between national laws was sought, periods characterized by different models of capitalism and thus different approaches to harmonization. The first period was characterized by a harmonization program outlined largely before the UK's accession to the then-EEC, one dominated by a German approach emphasizing a "coordinated" model of capitalism that did not center on shareholder value maximization. The second period, which began in the late 1990s after a lull in harmonization efforts, was in contrast more heavily influenced by the UK and centered on a more "liberal" model of capitalism focusing on shareholders and, increasingly, the stock market.

Part III: Asia

After this come contributions discussing the evolution of corporation law in modern east and south Asia. We begin with *Teemu Ruskola's* "Corporation Law in Late Imperial China." Here Ruskola argues, against much received wisdom, that even before the introduction of Western law in China at the turn of the 20th century China had entities analogous to the business corporation in the form of "clan corporations." Developing within a Confucian tradition that looked askance at profit-seeking and saw the family, rather than the natural person, as carrying a legal personality, Clan corporations initially developed out of ancestral trusts, formed to pool property to provide for ancestral sacrifices. The ancestral trust, however, lent itself to the creation of large, for-profit business enterprises, often with unrelated investors and expert managers—enterprises clothed in a form acceptable to Chinese attitudes at the time, but with many of the characteristics of modern Western corporations. What differentiated these organizations from European or American counterparts was not, Ruskola makes clear, anything essential about their nature, but rather the "vehement *ideological* insistence on kinship as the organizing principle, even in the case of large clan corporations in which kinship was the most threadbare fiction and many of the governing relations *in fact* originated in contract, not kinship."

Modern Indian corporation law is the subject of *Umakanth Varottil's* chapter. He identifies in the development of Indian corporation law since 1850 an oscillation between stakeholder and shareholder primacy views of the corporation. Colonial India's corporate law, imposed by England, drew on English corporate law and treated the company as a private matter with little obligation to non-shareholders—a view that carried over into the early days of Indian independence. By the 1960s, however, India's embrace of socialism led to a change in its company law, as a view that the company had a public character, not just a private one, led to the addition of new protections for constituencies including employees, creditors, and consumers. This stakeholder trend was in turn reversed in the 1990s, with deregulation and adoption of new corporate governance requirements and a disclosure-based securities law regime, both targeted at protecting shareholders. In the latest twist, the Companies Act, 2013 has again moved Indian corporation law in the stakeholder direction, providing greater protection to non-shareholders and, even more striking, mandating that large companies spend at least 2 percent of average net profits on social causes. As the chapter shows, while

originating in English company law, Indian law has diverged sharply from it, driven by India's own distinctive economic and political imperatives.

Bruce Aronson's chapter on the evolution of Japanese corporation law challenges views relying on a stereotyped vision of Japan in which informal relationships between businesses and the state, and a cultural disposition to avoid disputes, have produced a system in which formal law does not matter. To the contrary, he argues that formal law has mattered a great deal in Japan, and provides an account of Japanese corporation law since 1868 marked by "constant, if gradual, change over time; significant experimentation with corporate law to meet businesses' needs; flexibility and choice rather than rigidity; and practical efforts to adopt over time to changing political, economic, and social circumstances." His chapter follows Japanese corporation law through two eras, each of which saw foreign models profoundly influencing Japanese legal development. The first began with the Meiji period, where European, and especially German, law shaped Japan's first comprehensive corporation law, the Commercial Code of 1899: the second commenced after World War II when US law deeply influenced many areas of Japanese law. The chapter continues by following Japanese corporate law and corporate governance through the postwar periods of Japanese triumph and stagnation, and concludes in the 21st century, where it speculates that a third era of corporation law may have appeared, as Japan increasingly pursues a multipolar model focused on growth and the importance of "soft law."

Part IV: North America

The volume's focus then moves to North America. The development of Mexican corporate law is examined in *Aurora Gomez-Galvarriato* and *Gustavo A. Del Angel's* chapter. Their account of Mexican corporate and commercial law begins with that law's origins in the regulations Spain established for governing Mexico when it was still the viceroyalty of New Spain, moving through new laws adopted after Mexican independence and up to changes made in the early 21st century. This chapter shows Mexico's law being formed by cycles of globalization, from laws originating via New Spain's role within the Spanish empire to recent legal changes spurred by Mexico's contemporary integration with the global economy and international agreements. It also shows the law's evolution as it was pulled by two sometimes-contrary policy goals, as the government sought to both play an active role in the economy and to promote economic growth.

In his account of the history of corporation law in Canada, *Fenner L. Stewart* connects the law's development to both Canada's distinctive social-economic-political development and its complicated attitude towards its neighbor to the South. Initially, Canadian corporate law and the Canadian corporation itself lagged those of the US; in particular, with the exception of disclosure requirements, where Canada was a leader, its corporate law was less developed and more fragmented than that of the US well into the 20th century. Indeed, Canadian corporate law was not thoroughly reformed until the late 1960s and early 1970s, at which time Ontario adopted a Business Corporations Act that drew heavily on US models; a Federal act, called the Canada Business Corporations Act (CBCA), followed five years' later and set the pattern for other provincial corporate laws. These acts were surprisingly shareholder-friendly given their borrowings from US models, a development Stewart explains by pointing to the larger political context, particularly the growth of Canada's robust welfare state beginning in the 1940s. In his account, Canadian stakeholders did not demand protections in corporation law because they felt well-protected by other legal frameworks. Despite these differences, Stewart concludes that in fact Canadian corporation practice has diverged little from that of the US; its more shareholder-friendly statutes, and later judicial decisions that suggested a stakeholder-friendly approach as well, have not translated into shareholder (nor stakeholder) empowerment, and "the reality is that managerial power is at least entrenched as it is in the United States."

Finally, we turn to the United States. In his contribution to the volume, *Robert E. Wright* traces the origins of both for- and non-profit corporations in the US by studying corporations in the era of "special chartering," when each corporation had to seek its charter from a state legislature. Defining the corporation as an organization with the right of perpetual succession, Wright documents that over 22,000 corporations were granted charters via special incorporation in the US between adoption of the Constitution and the Civil War, and provides data strongly indicating that as many non-profit corporations, ranging from churches to fraternal societies, were also formed during this period. If anything, he points out, his study may undercount, as his data does not include many small associations that formed under articles of incorporation and asserted corporate rights without actually seeking charters. Corporations existed in all sections of the nation, and drew in a broad spectrum of Americans as shareholders and participants. As the first American treatise on corporation law put it, "[t]here is scarcely an individual of respectable character in our community, who is not a

member of, at least, one private company or society which is incorporated." Wright shows his readers that even early on the US was not anti-corporate but rather teeming with individuals eager to form and join corporations.

Moving forward, *Dalia T. Mitchell* traces the development of US corporate law across the 20th century by following the thread of fiduciary duties. At the beginning of the century, she shows, corporate directors were held to high legal standards, regarded by the law as trustees for shareholders (and, briefly, for the community as well)—an approach to fiduciary duties she attributes to widespread fears of corporate overreach. Over the century's course, however, as fears of corporate power receded, judges and legal scholars lowered the standard. By mid-century directors were seen not as trustees for shareholders but as their representatives, and by the end of the century directors were regarded as agents for largely passive shareholders. At each step directors' fiduciary mandates shrank, so that, by the 21st century, all that was required of directors was that they followed certain procedures and did not act in subjectively bad faith. Shareholders seeking protection were to look not to the law but to the markets. Here the history of modern US corporate law is a history of failure to protect shareholders and society.

Next come two chapters taking a tighter focus on the history of corporate social responsibility (CSR). *William W. Bratton* and *Michael L. Wachter's* contribution re-interprets the *ur-texts* of modern disputes over CSR, the 1931–32 debates over corporate managers' duties waged between Adolf A. Berle and Merrick Dodd in the pages of the *Harvard Law Review*. Today's debates over CSR are often traced back to this exchange, with Berle seen as an early advocate of shareholder primacy and Dodd a precursor to stakeholder views of corporate law. Yet Bratton and Wachter contend that Berle and Dodd argued against a shared background of assumptions concerning corporatism—the belief that politics should be organized around a limited number of different groups to which individuals bear allegiance (e.g., labor unions or business associations), with the government setting priorities and coordinating activities among these groups. Corporatist views, alien to modern readers, united Dodd and Berle, and the ideology's absence in today's debates serves to distance Berle and Dodd from us, and block any easy link between them and today's disputes in corporate law.

After this, *Lyman Johnson's* chapter looks at the development of US corporation law in relation to larger demands for corporate social responsibility, and finds a paradox: since the late 19th century, even as the large corporation was increasingly recognized as having a distinct existence as a legal person, and came to wield increasing influence on a

range of stakeholders, from employees to communities to the environment, corporation *law* narrowed its concern to the relationship between management and shareholders. Paralleling these developments, corporate theory by the late 20th century largely disregarded the existence of a distinct corporate personality and emphasized instead a view of the corporation as simply an aggregate ("nexus") of freely associated individuals. Following these developments, corporate social responsibility has been left to bodies of law outside corporate law, or to evolving sets of norms and practices outside the law altogether.

The final chapter in this volume steps back from specific historical accounts to discuss more sweeping models that may explain the development of modern corporate law. Despite historians' oft-expressed resistance to theoretical models, *Amitai Aviram* argues that such models are useful in identifying both the most significant empirical facts to be discovered and which research questions should be asked. As he writes, "history (in the sense of the empirical project of representing the past) and models need each other." He then explains how evolutionary models—models that assume the law, in this case, is "significantly determined by competition between various actors over resources"—can go far to explain aspects of the development of corporate law, taking as his example the well-known development of modern US corporate law and specifically the triumph of Delaware law. Looking at three rival evolutionary models of regulatory competition—horizontal (state v state), vertical (state v Federal government), and intrastate (between interest groups)—he concludes that a model incorporating both state-versus-Federal competition and in-state interest group competition best explains the enduring dominance of Delaware corporation law.

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PART I

TAKING SHAPE

1. Islamic law and economic development

Jared Rubin

1. INTRODUCTION

This chapter discusses the connection between Islamic law and economic development in the historic and contemporary Middle East. I make the case that Islamic law has had a detrimental impact on Middle Eastern economic growth for two related reasons. The first is that there are elements of Islamic doctrine which make Islam conducive to legitimizing political rule. This entails that Muslim rulers have historically given religious authorities a seat at the bargaining table over laws and policies. Secondly, this is problematic for economic growth because until quite recently rulers gave the clerical class purview over commercial law. Islamic law addresses many aspects of business, including laws of partnership, trusts, lending, and finance. Most of these laws were formed in a pre-modern economic context and are thus not conducive to supporting business in a changing economic environment.

One of the most important consequences of the processes described in this chapter is that the idea of the corporation was completely absent in Islamic law until it was imposed by Europeans in the middle of the nineteenth century (Kuran 2005, 2011). Despite the fact that the Middle East was economically far ahead of Europe for centuries following the spread of Islam, Islamic partnerships rarely included more than three or four partners and rarely lasted for any significant duration. Why did Islam lack the concept of a corporation – or anything close to a corpus of corporate law? This chapter argues that, like numerous other commercial laws under the purview of the clerical class, the absence of legal change to accommodate a changing economic environment was part of a broader political economy equilibrium in which the religious elite played an important role in legitimizing political rule.

Indeed, it is not enough to simply claim that Islamic law is not conducive to economic growth and thus economic growth did not occur. After all, Christian canon law was also not suited for a modern economy, but it hardly hampered economic growth in Western Europe. In Medieval Europe, secular law replaced canon law in nearly every aspect of law except those confined to strictly religious matters (Berman 1983). The

real question, therefore is why secular law did not replace Islamic law in the Middle East until the nineteenth and twentieth centuries. The answer to the question is not solely a demand-side one; when secular law arose to preeminence in Europe, the Middle East was ahead of Europe economically, technologically, and scientifically. So it cannot merely be the case that Middle Eastern populations did not demand change to outdated commercial laws. This chapter argues that the lack of change in Islamic law is a supply-side phenomenon. In other words, there was little will to update laws from those in charge of creating and interpreting laws: the rulers and the religious elite. The lack of will to update laws was not due to conservative preferences, but was a result of the incentives faced by all of the relevant players. This insight was explicated in a game theoretic model laid out in Rubin (2011, 2017), and I briefly spell out its intuition in the following section.

In short, this chapter argues that there is indeed a negative connection between Islamic law and economic growth. But understanding the causal connection between the two is important, because it is easy to derive simple but misinformed connections between the two. I argue that the primary causal link is not some inherent conservatism in Islam or any notion that Islam is inherently antithetical to commerce. Instead, I focus on the role that religious legitimacy played in Middle Eastern rule and how this affected the incentives of all the relevant players who had some power to affect laws and policies.

2. STAGNATION IN ISLAMIC LAW

It was a well-worn trope among the Orientalists of the mid-twentieth century that the 'gate of *ijtihad*' was closed at some point around the tenth century (Schacht 1964, Ch. 10; Coulson 1969; Weiss 1978). *Ijtihad* is a term for 'independent reasoning', and clerics practiced it frequently in the first three to four Islamic centuries as new situations called for new interpretations of old laws. Yet, the Orientalist literature claims that an informal consensus arose among the clerical elite around the tenth century that *ijtihad* was no longer a valid way of seeking truth. Instead, jurists were supposed to only follow precedents (*taqlid*). This meant that juristic ingenuity was stifled precisely at the time that Sunni Islam consolidated into four schools: Hanafi, Hanbali, Maliki, and Shafi'i. To the extent that this is true, it meant that Islamic law was incapable of responding to changes in the economic, political, and social environments where it was practiced.

A recent literature challenges the idea that the gate of *ijtihad* was ever really closed in theory or in practice (Hallaq 1984, 2001; Gerber 1999). But even this literature suggests that *ijtihad* was practiced less frequently after the tenth century than it was in the first few Islamic centuries. It is not the intention of this chapter to enter into this debate. The only point that matters is that Islamic law did seem slower to respond to new exigencies after the tenth century. The questions this chapter addresses are: 'why did reinterpretation of Islamic law slow down after the tenth century?' and 'What did this mean for Middle Eastern economic outcomes?'

A simple explanation for the slowdown of reinterpretation is that Islam is simply 'mystical' or 'conservative' and thus not amenable to change. Indeed, a large literature dating to at least Max Weber suggests just this (Weber 1922; Cromer 1908; von Grunebaum 1966; Lewis 1982, 2002). But such an explanation cannot explain why reinterpretation of Islamic law was so active in the first few Islamic centuries. If Islam is inherently conservative, why did the corpus of Islamic law change so much prior to the tenth century? Why did Islam apparently not impede the growth of Middle Eastern economies after its spread?

A satisfactory explanation must be able to account for the ultimate slowdown in reinterpretation of Islamic law without appealing to anything inherent about the 'nature' of Islam. Indeed, it is useful to consider what it means for a religion or a corpus of law to be 'conservative'. One may consider a religion to be conservative if it does not change in the face of changing circumstances. But this does not necessarily mean that a conservative religion is incapable of change. The key point this chapter makes is that conservatism is an *outcome*, not a cause or a preference. The same laws or doctrine remain in place because it is not in the incentive of those with capacity to change them to do so. Conservatism is therefore not the result of some desire to 'stick to old practices' or 'return to the past' regardless of the circumstance. This idea of conservatism is useful for analysis, because it points us to the key players involved in the creation of law and focuses our attention on the incentives they face.

Rubin (2011, 2017) provides a framework for thinking through who the key players are in the creation of laws and policies and how their incentives may result in conservative outcomes. It focuses on rulers and the people and organizations (hence, agents) that *propagate* rule. Agents propagate rule by helping keep a ruler in power. They can do this by providing legitimacy or coercion. Legitimacy is useful because it increases the number of subjects who believe the ruler is the rightful ruler and thus has the right to make laws and policies. In the Middle East, religious authorities have historically been among the most important

legitimizing agents. They have the capacity to legitimize for two reasons: (1) they have influence with the population; and (2) Islam is particularly conducive to legitimizing rule. The latter point is important. Numerous passages in the Qur'an and hadith literature support the legitimizing role of Islam. For instance, the hadith of al-Bukhari states:

> The Prophet said, 'It is obligatory for one to listen to and obey (the ruler's orders) unless these orders involve one disobedience (to Allah); but if an act of disobedience (to Allah) is imposed, he should not listen to or obey it.' (Vol. 4, Book 52, No. 203)

In short, this hadith supports the idea that subjects should obey a ruler who 'acts like a good Muslim'. This notion has been incredibly useful for Middle Eastern rulers, who have frequently relied on religious authorities for justification for controversial actions, from permitting tobacco to attacking fellow Muslims. So long as the action could be construed as being consistent with Islam, 'good Muslims' were supposed to follow the ruler.

The importance of religious legitimacy in determining Middle Eastern legal and economic outcomes becomes clearer when one considers its implications for political economy. Assuming that the ruler's primary objective is to stay in power, he must bring those people capable of propagating his rule – his propagating agents – to the political bargaining table. These agents will not propagate his rule for free: they will expect some say in laws and policies in return. This is the main reason that Islamic law affects economic outcomes. Religious authorities had something they could offer Middle Eastern rulers: legitimacy. In return, they wanted Islamic law to cover as many aspects of society as rulers would allow. This did not mean that rulers gave clerics free reign over all aspects of law; where it suited them, rulers decreed laws over which religious authorities had no purview. For instance, the Ottomans established the *kanun*, or 'secular law'. The *kanun* and Shari'a were not always consistent, and when they clashed the religious establishment generally found some way to cloak the Sultan's desires in a veil consistent with Islamic principles.

Importantly, Middle Eastern rulers generally left purview over most aspects of commercial law to the religious class. The reason is simple: commercial law only indirectly affected the ruler's capacity to rule, so it was worth the cost of ceding domain over commercial law in return for legitimacy. This is not true of laws regarding taxation, for instance, and therefore rulers generally maintained flexibility to tax in any manner they desired.

Understanding this dynamic between political and religious authorities helps shed light on why a 'conservative' outcome arose in the Middle East with respect to Islamic commercial law. Consider the incentives and actions of the key players: rulers, the religious establishment, and the economic elite (e.g., merchants, money-changers, and producers). The economic elite are a player in the game over commercial law because it is in their interest to have the law updated in response to economic exigencies. However, they are only minimally incentivized to 'push the envelope' and act outside what the prevailing legal regime permits. On the one hand, the economic elite may find some benefit in transgressing some aspects of Islamic commercial law if the law is unsuitable for the prevailing economic conditions. However, they face a 'double cost' from doing so: a 'spiritual', intrinsic, cost from breaking the dictates of religious authorities (whose opinion they presumably care about) and a worldly, explicit, cost associated with their actions potentially being voided in court. Where the cost is large enough it will not outweigh the benefits and the economic elite will refrain from transgressing the law.

Consider how this affects the incentives of rulers and religious authorities. If few people transgress the law, rulers have little incentive to change it. Even if it might mean an expanded tax base, changing laws over which religious authorities have purview threatens to undermine one of their primary sources of legitimacy. The costs of changing the law are therefore immense, and if the economic elite largely abide by the law in any case, the perceived benefits are low. The cost-benefit calculation for religious authorities can be thought of in a similar manner. They stand to lose credibility – and hence their capacity to legitimize – if people openly disobey their dictates. But in the situation described above, this does not happen; the economic elite find it too costly to disobey the laws and so they rarely do. Meanwhile, reinterpreting Islamic law is quite costly. Part of the reason religious authorities have the power they do is their monopoly over what are perceived as 'eternal' truths. Reinterpretation of these truths threatens to undermine their eternalness and thus the relevance of the interpretations of religious authorities. Hence, if the economic elite rarely transgress commercial laws, it is not in the interest of the clerical class to update these laws, even if economic circumstances have changed significantly since the time the laws were initially enacted.

This logic explains how conservativism in Islamic law is an equilibrium *outcome*. It is not necessarily an inherent feature of Islamic law itself. It can also help explain why there was a flurry of reinterpretation in the first few Islamic centuries. As the corpus of Islamic law grew in the first few centuries, jurists were generally willing to codify legal practices that had been custom for generations. Where practices flew in

the face of Islamic law, economic actors generally found workarounds. A famous example is the double sale, a ruse meant to skirt the ban on interest. The double sale consisted of two sales, one for a good at a set price, the second for the same good at a higher price, payable at a future date. It could be conducted as follows: Omar sells a rug to Mahmud for 100 dinars and immediately buys it back for 110 dinars, payable in a year. The upshot is that Omar keeps his rug, receives 100 dinars from Mahmud, and owes Mahmud 110 dinars in a year. This is ostensibly a 100 dinar loan at 10 per cent yearly interest. Yet, because it is construed as two sales, both of which are legal in Islamic law, jurists upheld the legality of such transactions. It was in the interest of clerics to permit such ruses. If the economic elite commonly and openly disobeyed the religious establishment, the clerics risked losing their primary source of influence: moral authority. Hence, as the corpus of Islamic law formed in the first few Islamic centuries, jurists had incentive to reinterpret law to accommodate pre-existing practices.

The intuition laid out above also indicates that once economic actors were able to act within the confines of the law – even if they had to incur a cost associated with a ruse to make their actions cohere to the law – they had little incentive to 'push the envelope' any further. They received most of the benefits from economic interactions while not incurring the potential costs associated with breaking the law. Even when new economic circumstances arose – meaning new chances for increased profits – the costs of breaking the law were too high relative to the marginal benefits. And since rulers were unlikely to permit anything forbidden by the religious establishment, it was in the interest of the economic elite to continue with 'business as usual', even if it meant forgoing new economic opportunities. This also entailed that there was little incentive for clerics to adapt Islamic law to the new environment; if few were pushing for change and change is costly, change will not result. Hence, at some point Islamic law stagnated. This was a consequence of the incentives faced by the relevant players, not some attribute inherent to Islamic law.

This confluence of events had a retarding impact on the long-run development of Middle Eastern economies. Religious scholars had purview over commercial law, which they had little incentive to reinterpret. Merchants, manufacturers, and money-changers were not give a seat at the bargaining table and therefore had little ability to affect commercial policy or law (Pamuk 2004a, 2004b). This stifled or prevented the adoption and creation of new institutional forms such as the corporation and bank, neither of which arose in the Middle East until the nineteenth century. The following section highlights how these and numerous other

outcomes arose in the Ottoman Empire because of the political economy equilibrium where Islamic law played a central role in commerce.

3. ECONOMIC STAGNATION IN THE OTTOMAN EMPIRE

3.1 Stagnation in Commercial Law

While this chapter is about the connection between Islamic law and economic outcomes in general – not just in the Ottoman Empire – the Ottoman case is useful to study for numerous reasons. First, the data are much better and we know a lot more about the empire than we do about previous Muslim polities in the Middle East. Second, and more important, the empire very clearly stagnated just as parts of Western Europe were taking off. It was by no means obvious in the sixteenth century that the Ottoman Empire would eventually fall behind its Western European rivals. Territorially, the Empire expanded throughout the century and eventually ruled most of the North African coast, the Arabian Peninsula, the Balkan Peninsula, and most of the Middle East. The Ottomans threatened the great powers of central and southern Europe – Spain, Venice, and the Holy Roman Empire. Yet, by the end of the seventeenth century, the Ottomans had clearly fallen behind. One of the more overt symptoms of their relative stagnation was the trade capitulations the Sultan offered to many of the European powers. These capitulations gave the European economic elite customs relief, legal jurisdiction, and freedom from prosecution within the empire at the expense of the empire's own economic elite.

The intuition explained in the previous section sheds some light on why the Ottomans fell behind. The economic elite did not have a seat at the political bargaining table, and Sultans therefore enacted policies that were in their own interests or the interests of their legitimizing agents. One of the most important consequences of this arrangement was that the protection of property rights was highly irregular throughout most of Ottoman history. For instance, one of the most important Sultans, Mehmed II (r. 1444–46 and 1451–81) – conqueror of Constantinople, hence his name Mehmed the Conqueror – confiscated land held by both private owners and pious foundations (*waqf*) throughout his reign (Karaman and Pamuk 2010). These confiscations were highly unpopular and had to be scaled back by his successors. Another example comes from the early eighteenth century, when Sultans retracted tax farming contracts

at will when in a fiscal bind. By the end of the century, tax farm confiscations were commonplace (Balla and Johnson 2009).

A more overt consequence of Ottoman legitimizing arrangements was that commercial law remained within the purview of the religious establishment. The logic laid out above indicates why. The Ottomans benefitted immensely from religious legitimacy and therefore never had to negotiate with the economic elite. Indeed, ceding Islamic commercial law to some secular power would have undermined the very group supporting the Sultan's rule. What incentive was there for an Ottoman Sultan to undermine the clerical class for the benefit of the economic elite, a group with no seat at the bargaining table? As a result, commercial law rarely changed to address the changing needs of the economic elite because the group capable of changing the law – religious clerics – had little incentive to do so.

One consequence of inflexibility in commercial law was that restrictions on interest were never fully alleviated. From the first Islamic century it was possible to circumvent interest restrictions with *hiyal*, or ruses meant to have a transaction abide by the letter of the law de jure but simulated interest-bearing loans de facto. A classic example is the double sale discussed in the previous section. Such transactions permitted lending moderate amounts to known relations for centuries following the spread of Islam. As long as the ruse was conducted and the good exchanged could reasonably be construed as having the value of the transaction, both parties could be assured of the validity of the transaction. And Islamic courts usually supported such transactions. But the fact that such transactions were possible – at a cost – stifled the development of large-scale lending institutions like banks. For one, Islamic jurists would have disapproved of an institution that took deposits – and paid interest on those deposits – with the sole purpose of lending the deposits at higher interest. There was enough gray area in a transaction like the double sale conducted between two acquaintances that jurists were willing to turn a blind eye to a transaction that violated the spirit, though not the letter, of the law. There was no such gray area for a bank or any other type of institution whose sole purpose was borrowing and lending money. Consequently, no class of money-lenders existed in the Ottoman Empire – nor, likely, in previous Muslim polities – and lending remained relatively small in scale and conducted primarily among known relations (Jennings 1973; Kuran 2013). It was not until 1856 that the first successful bank opened in the Ottoman Empire, and even this bank was backed financially primarily by the British and French.

Rubin (2010) highlights another unforeseen consequence of Islamic interest restrictions: institutions capable of transacting impersonally on a large scale never emerged indigenously in the Middle East. The European experience is instructive for comparative purposes here. Rubin traces how the bill of exchange emerged in Western Europe as a credit instrument that permitted lenders to evade the Church's usury restrictions. The key difference between the Middle East and Western Europe was that secular authorities permitted evasions of interest that were prohibited by the Church. This entailed that medieval European lenders could be assured that their contracts would be upheld – generally in merchant courts – even if there were spiritual consequences. The upshot was that European lenders had incentive to engage in *interregional* lending; bills of exchange were only profitable as a financial instrument if lenders could take advantage of exchange rates in different regions.[1] This gave European lenders an incentive to form organizations capable of transacting with unknown people in distant lands. This incentive was realized most famously by the Medici bank, which established branches throughout Europe to deal in exchange transactions (de Roover 1963; Rubin 2010). The Middle Eastern near-equivalent of bills of exchange – the *suftaja* – never evolved into such an instrument, and consequently institutions making impersonal, interregional finance never formed. The key difference between the *suftaja* and the bill of exchange was that the *suftaja* was only valid if it were written and remitted in the *same currency*. Muslim jurists worried about illicit, usurious use of the *suftaja*, and therefore forbade its use for anything beyond its original purpose (eliminating the need to carry specie when conducting long-distance trade). Muslim lenders therefore never had the possibility of using the *suftaja* as an instrument of interregional finance, and the type of supporting institutions the emerged indigenously in Western Europe never did so in the Middle East.

There were numerous other consequences of commercial law falling under the purview of the clerical class. For instance, Timur Kuran (2001,

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1 Lenders were able to make profits by buying a bill in city A. Once the bill was remitted in city B, the lender could instruct his correspondent in city B to take the proceeds from that bill and buy a new bill, payable in the lender's home land, from another borrower. The key to making profit from the transaction was that the correspondent would purchase the second bill at a *different* exchange rate than the first one. The rate differential – which was part of the financial market equilibrium of the late medieval period (de Roover 1944) – permitted lenders a chance to profit on exchange transactions. For more, see Hunt and Murray (1999) and Rubin (2010, 2017).

2005, 2011) argues that the widespread approval and use of *waqf*s had numerous unintended consequences. A *waqf* was a pious trust with a mission fixed for perpetuity. From the first few Islamic centuries, *waqf*s were used to fund public goods such as fountains or schools. Founding a *waqf* was viewed as a pious act, and hence *waqf* founders generally gained a certain amount of social prestige. But Kuran notes that there was another reason one might endow a *waqf*: it permitted wealthy Muslims to evade inheritance laws. Under Islamic inheritance law – which the clerical class interpreted and enforced – numerous heirs had rights to the fortune of the deceased according to a pre-determined formula. If one wished to avoid this outcome and give the inheritance to a favored son (or, less frequently, daughter), one could found a *waqf* and pay a handsome sum to an heir to run it. This was perfectly legal within the context of *waqf* law, and it therefore permitted wealthy Muslims to avoid the splitting up of assets required by Islamic law. An unintended upshot was that capital was directed towards pursuits with fixed missions. If a *waqf* manager found a more productive investment for *waqf* funds, he was legally prohibited from investing those funds in such a manner. Consequently, a non-trivial portion of Middle Eastern wealth was held in organizations that were inflexible and therefore incapable of adjusting investments to meet the pressing needs of the day. For instance, if a *waqf* founder ordered that the *waqf* fund a *madrasa*, then funds emanating from that *waqf* could only support *madrasa* expenses, even if the educational needs of the population were met and other public goods were lacking.

Another consequence of Islamic inheritance law was that partnerships remained relatively small and simple throughout most of Middle Eastern history (Kuran 2005, 2011). Indeed, partnerships rarely included more than three or four participants and were often short-lived, ending after a merchant voyage or two. Larger partnerships never became common enough to encourage Islamic jurists to consider formulating a corpus of law akin to Western corporate law that would help address the needs of growing enterprises. Why did the corporation – or any similar form of large partnership with characteristics such as asset shielding and legal personhood – ever emerge indigenously in the Middle East? And what role did inheritance law – and the broader political economy equilibrium in which the religious elite played an important role in legitimating rule – play in this process?

The answer to these questions lies in the interaction of Islamic partnership and inheritance law. Partnerships were the primary way that most Muslims combined capital, effort, and expertise in order to grow their wealth (Udovitch 1970). This was also true in medieval Europe.

However, in the late medieval and early modern periods, European partnerships became progressively larger and more complex, evolving from basic partnerships (*commenda*) into family firms, joint-stock companies, and ultimately corporations. Each step in this evolution helped solve a problem associated with basic partnerships; family firms allowed for entities that lived beyond the life of the individual members by relying on social-familial trust between partners, while joint-stock companies introduced limited liability and tradeable shares, both of which greatly increased a company's capacity to attract investment. Such an evolution never occurred in the Middle East, and partnerships mostly remained simple into the nineteenth century. Kuran (2005, 2011) argues that Islamic inheritance law played an important role in this institutional stagnation. Islamic partnership law dictated that a partnership was to be immediately dissolved upon the death of any member, although it could be (and often was) immediately re-formed by the partner's heirs. Yet, since Islamic inheritance law split inheritances among numerous heirs according to pre-determined Qur'anic dictates, entering into a large partnership was risky. The cooperation of all (or nearly all) the heirs was needed in order to reconstitute the partnership. If enough of the heirs needed to spend their inheritance the partnership would be dissolved. This could strike a major financial blow to the partners. For most partnerships to succeed, some level of certainty about the future is necessary. An early dissolution could force the original partners to dishonor already agreed-upon contracts or force the cancellation of operations critical to the partnership's viability, such as shipments or large purchases.

The upshot, Kuran (2005, 2011) argues, is that there was little incentive for merchants or financiers to form partnerships with many members, or even to form long-lasting partnerships within a family. If any member of the partnership died, any number of heirs of the deceased partner could threaten the future viability of the partnership. The simplest way to avoid this fate was to form partnerships with few members and limited time horizons. The more members or the longer the time horizon, the more likely it was that one of the partners could die, especially in a period with relatively high mortality rates. The dynamic effects of the persistent simplicity of Islamic partnerships are apparent when compared to the evolution of European partnerships. As European merchants slowly grew their partnerships and came up with creative mechanisms for financing larger ventures, legal changes supporting such actions became more commonplace. This process ultimately led to a large and varied body of corporate law emerging in numerous parts of Europe. Such a process never happened in the Middle East. In the absence of any

incentive to engage in larger or longer-lived partnerships, Muslim merchants never had any incentive to push for legal changes that could accommodate such partnerships. In turn, rulers and religious authorities therefore never had the incentive to change the law. This is precisely the 'conservative equilibrium' described above, in which conservative *outcomes* arose due to a lack of incentive on the part of any of the relevant players to push for change. As a result, the corporation never emerged indigenously in Islamic law.

Indeed, it is likely that Ottoman jurists could have addressed the retarding effects of partnership, inheritance, and usury law had they so desired. But the framework laid out in the previous section explains why they had little incentive to do so. Such changes would have required a *costly* reinterpretation of 'eternal' doctrine. Since the Sultan was willing to cede purview over commercial law to the clerics, there was little incentive for clerics to update the laws. In other words, the political-economy equilibrium of the medieval and early modern Middle East was one in which the Sultan gave the religious establishment purview over commercial law, clerics in turn legitimized the Sultan, and the economic elite remained relatively powerless.

3.2 Judicial Bias

Another consequence of the political-economy equilibrium described above is that the Ottoman Empire lacked an impartial judicial system. Part of this was due to certain features of Islamic law, which – like many other pre-modern legal systems – favored certain peoples over others. For instance, Islamic law famously favored men over women. Judges were trained to value the testimony of men over women; this is not to say that women's testimony was completely devalued, just that the benefit of the doubt was given to men. For this reason, men were much more likely to serve as witnesses in legal proceedings (Kuran and Rubin 2017). Similarly, judges were trained to value the testimony of Muslims over non-Muslims, although there is little evidence that strict equivalency rules were ever employed (e.g., one Muslim = two Christians). A final source of judicial bias in the Ottoman Empire was that the Sultan directly appointed judges, many of whom sought promotion within the judicial hierarchy. This meant that it was unwise for an ambitious judge to rule against an elite with links to the Sultan unless the weight of evidence against the elite was overwhelming (Imber 2002, ch. 6; Kuran and Rubin 2017).

Recent studies confirm that Ottoman courts were indeed partial to these favored classes. Kuran and Lustig (2012) analyzed numerous court

registers from seventeenth-century Istanbul and found that Islamic courts regularly showed favor for Muslims and government officials. Coşgel and Ergene (2014) find similar biases in their analysis of court outcomes in eighteenth-century Kastamonu, an Ottoman town in north-central Turkey. They show that, conditional on the characteristics of the plaintiffs and the defendants, elites were much more likely to win their case than those from poorer families.

How did these judicial biases affect economic outcomes in the Ottoman Empire? Kuran and Rubin (2017) suggest that an unintended consequence of judicial bias was that it raised the cost of credit for those who benefitted the most from it: elites, Muslims, and men. They find that these three groups paid between 2 to 4 percentage points higher interest rates on loans, all else equal. Basic economic logic explains why. A lender is unlikely to enter into a loan contract with a borrower unless he or she can be fairly certain that the borrower will repay the loan. In a world where borrowers of a certain socio-economic class can renege on repaying loans with relative impunity, the cost of their privilege is that lenders will charge them higher interest rates to make up for their greater default risk. This relationship between socio-economic status and interest rate found in the Ottoman Empire is therefore the opposite of what one expects to find in the modern context. In the twenty-first-century developed world, the wealthy and middle class have resort to mortgages and credit cards at relatively low interest rates while the poor are relegated to pay-day lenders and pawnshops to smooth consumption. But this is precisely the point: it was the biased nature of Ottoman courts – unlike modern courts, which are relatively unbiased with regard to financial transactions – that flipped this correlation.

The fact that Ottoman elites paid more for credit almost certainly had a dampening effect on economic activity. After all, those in the best position to invest in capital were precisely those who paid the highest borrowing costs. One may be motivated to ask, ‘why didn’t male, Muslim elites – who dominated the Ottoman government – seek to reduce these biases that hurt them so much in financial markets?’ The answer to this question follows from the logic laid out above. Such a change would have required a fundamental altering of Islamic law – something which was very much not in the interest of the clerical class. Since clerics were the primary legitimizers of the state, the Sultan had little incentive to restrict their purview over commercial law. It was only in the mid-nineteenth century, by which time the Ottomans had very clearly and painfully fallen behind the leading powers of Western Europe, that efforts at major institutional reform were proposed (under a series of reforms known as the Tanzimat). Not surprisingly, the levelling of the

judicial playing field was one of the first reforms undertaken, as it directly benefitted those in charge of implementing the reforms. But by this point it was already too late. The Ottoman Empire had fallen far behind its European rivals with whom it was previously on an equal footing, and the weight of this failure led to its ultimate collapse after World War I.

4. CONCLUDING THOUGHTS

The point of this chapter is to make a connection between Islamic law and economic stagnation in the Middle East. It argues that stagnation in Islamic law did indeed have a dampening effect on Middle Eastern economic growth. But it in no way claims that Islam is incapable of change or it is some inherent Islamic conservatism that is at fault. Instead, it attempts to explain stagnation as an *equilibrium outcome*. Change only occurs when it is an incentive of all the relevant players for change to occur. When some of the players have the incentive to block change – even change that may be beneficial for society as a whole – change may not occur.

It is important to distinguish between conservatism as a preference and conservatism as an outcome. If conservatism is a preference of Muslims in general and Islamic scholars in particular, then change in the present or in the future will be next to impossible. To the extent that preferences are immutable – and they are certainly much more immutable than outside economic conditions – a society with conservative preferences will never adapt to a changing world. But this chapter suggests that this is a bad way of thinking about conservatism. Conservatism is an outcome, not a cause. It is the result of an absence of incentive to change, not a disinclination to change in itself. In any case, it is hardly true that Muslims have always been conservative on economic or other issues.

Stagnation in Islamic law was therefore an outcome associated with a political economy equilibrium. Rather than blame Islam or Islamic law for the underperformance of Middle Eastern economies, this insight suggests that Islamic law is culpable only to the extent that it played a role in sustaining this equilibrium.

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2. Business organizations in India prior to the British East India Company

*Vikramaditya Khanna**

I. INTRODUCTION

The modern scholarship on the history of business organizations does not devote much space to the history of business in the Indian Subcontitent before the British East India Company (BEIC). However, for much of recorded history India represented a very large part of the global economy (Maddison 2006, Tomlinson 2003) and business within its changing borders must have been quite prevalent. This chapter explores the historical development of business organizations in India prior to the rise of the BEIC and highlights some of their key features. In particular, this chapter provides an overview of the development of the *sreni* – a complex organizational entity that shares similarities with Medieval European guilds, producers' cooperatives, and corporations – which was being used in India from around 800 B.C.E. to 1000 C.E. (Khanna 2006).[1] Even after its gradual demise, *circa* 1000 C.E., the *sreni* appears

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[1] This chapter summarizes and builds on some of the findings in Khanna (2006), which provides a comprehensive inquiry into business entities in ancient India, including the *sreni*, and addresses a number of theoretical and historical questions of interest beyond those discussed in this chapter. I refer the reader to Khanna (2006) for a more detailed discussion of the *sreni* and economic conditions in ancient India.

to have had longer lasting effects on business activity in the Subcontinent. Recent research suggests that some *sreni* features may have impacted Mughal era institutions in ways that had important repurcussions for growth in India (Khanna 2017).

More generally, the analysis suggests that the factors identified as being relevant to the development of European business organizations, such as increasing trade, methods to contain agency costs, and methods to engage in asset partitioning or entity shielding (Hansmann and Kraakman 2000, Hansmann, Kraakman and Squire 2006) were also relevant to the development of the *sreni*. Further, details on *sreni* governance and regulation suggest quite sophisticated attempts to address agency costs and incentive effects as well as considerable agility in adapting to changing business conditions. Studying the *sreni* may then provide useful insights on the development of business entities as well as information on other issues of scholarly interest that I note towards the end of this chapter.

I begin by briefly describing, in Part II, what organizational entities are and the factors that are thought to encourage their growth. Part III then summarizes the primary attributes of the *sreni*, while Parts IV through VIII examine the social, political and economic conditions in different time periods in Ancient India and how they relate to the growth of the *sreni*. Moreover, these parts provide details on the *sreni* and how its features and general development correspond well to economic factors and concerns. Part IX explores the lingering impact of the *sreni* in time periods after its decline and Part X provides a summary of the key findings of this chapter and some commentary on how study of the *sreni* can inform and enrich our understanding of topics of considerable scholarly interest. Part XI concludes.

II. ORGANIZATIONAL ENTITIES AND WHAT ENCOURAGES THEIR GROWTH?

In this chapter the term 'organizational entities' (OE) refers to entities that have 'a designated pool of assets and an agent or agents with ongoing authority to enter into contracts that, as a default rule of law, are bonded by those assets' (Hansmann, et al 2006). Business organizations are OE used primarily for business purposes, such as partnerships and corporations. Corporations are business organizations with the following key features: (i) separate legal entity status from its shareholders, owning

property in its own name, and continuing existence even if its shareholders die or transfer their shares; (ii) possessesing centralized management so that shareholders need not approve every operational decision; (iii) free transferability of a shareholder's interest in the corporation; and (iv) limited liability – shareholders are only liable for the amount of money they have invested (Clark 1986, Easterbrook and Fischel 1991, Allen and Kraakman 2016, Klein, Ramseyer and Bainbridge 2015).

A number of factors are thought to influence the development of OE, which are usually described by reference to how they influenced the growth of the corporate form. On the demand side, increases in trade and changes in technology during the industrial revolution are thought to have increased demand for capital from dispersed investors, which was facilitated by entities like the modern corporation (Clark 1986, Hansmann et al 2006).

The importance of growing trade is that it creates incentives for collective efforts and OE of some kind. When trade increases people tend to travel more to sell their wares (Weber 1961, North 1981, Grief 1993, Thapylal 1996). Travelling has not always been easy, especially if the traders are moving through foreign and dangerous territory. In such circumstances being in a group of traders may provide some protection against robbers and thieves and also some method of spreading the risks of the journey. Moreover, as trade and production increase the advantages of working in a large group (i.e., economies of scale) are likely to be quite considerable (e.g., spreading the fixed costs of production) (Kohn 2003, Weber 1961). Further, as trade increases the gains from specialization, and the sustainability of it, are likely to increase (Weber 1961, Das 1980).

The importance of technological change is that certain changes may require large amounts of capital to utilize them (e.g., industrial revolution) (Clark 1986, Allen and Kraakman 2016). This often requires collective effort in raising and contributing capital because the amount may be too much for any one party to be able, or willing, to provide. Corporations are well suited to attracting passive investors to collectively fund an activity.

On the supply side, the corporate form developed against a pre-existing set of legal and institutional conditions that hastened its development. For example, one feature of the corporation (and many business organizations) is that it partitions the assets of the corporation from that of its owners (Hansmann, et al 2006). Thus, when a creditor transacts with the corporation it knows which assets (those of the corporation) stand behind the transaction. Similarly, when a creditor transacts with the owners in their individual capacities it also knows which assets (those of the

owners) stand behind the transaction. An important aspect of this is that corporate assets are then in a sense shielded from the claims of the personal creditors of individual shareholders (i.e., entity shielding or asset partitioning). Knowing this is important, in part because it helps creditors know which assets they need to focus their monitoring efforts on – the corporation's or the owner's – and thereby reduces the creditors' monitoring and information costs compared to a world where such entity shielding was not possible (Hansmann et al 2006).

Of course, for this to happen one needs to be able to identify which assets belong to which entity (corporation or owner) and monitor movements of assets from one entity to another. Indeed, the historical development of the corporate form in Europe suggests that the ability to patrol the boundary between different sets of assets was a very important factor in OE development. This becomes easier as accounting systems become more refined and as bankruptcy proceedings become more sophisticated (Hansmann et al 2006).

Another critical feature of the corporate form and most OE is that they often bring together a number of people to invest in and run an entity. If rules to address the potential conflicts of interest among owners and between managers and owners are not available then these entities will grow more slowly (Allen and Kraakman 2016). Fiduciary duty doctrine, some securities regulation, and reputational mechanisms serve to address these agency cost concerns. But for these to function properly there must be monitoring methodologies in place for the owners to have the information necessary to enforce these duties or to impose reputational penalties (Easterbrook and Fischel 1991, Allen and Kraakman 2016, Grief 1993, Klein and Leffler 1981, Bernstein 1992, 2001, Ellickson 1985). These could include geographic proximity so that one party can directly observe the other, simple gossip, methods of verifying the production, delivery, and receipt of goods and services, and reliance on third-party intermediaries.

Thus, one would expect the development of business organizations, such as the corporation, to be more likely when the demand for production and trade is increasing and when methodologies are present for monitoring the behaviour of owners and managers by creditors and other owners. Such situations enhance the value of organizational forms and also help to contain their costs, such as their agency and creditor information costs. Of course, other factors are also important (e.g., general economic conditions, property and contract law), but for our purposes it is sufficient to begin with the ones identified above.

III. ORGANIZATIONAL ENTITIES IN ANCIENT INDIA

Ancient India appears to have relied on a variety of organizational forms of activity – I focus on the *sreni* because we have the most available information on it. A *sreni* was an OE that was normally composed of people who were engaged in a similar trade, but not necessarily of the same caste (Majumdar 1922, Thaplyal 1996). The *sreni* could have a large number of members (sometimes over 1000, who all shared in the assets and liabilities) and it was run through a headman and later executive officers as well (Thaplyal 1996). The *sreni* shares some similarities with medieval guilds, corporations, and other kinds of OE, but is not easily subsumed within any of them. To gain a better understanding of this entity I examine the attributes of the *sreni* and its importance in Ancient Indian life. The features of the *sreni* at their peak are detailed in Table 2.1 below.

Before embarking upon a discussion of these features, a caveat is warranted. When examining ancient entities there is a risk of projecting on to them our views of how things are now thereby biasing our assessment. To help assuage some of these concerns, this chapter examines the *sreni* in the context of the political, economic and social backgrounds of the differing periods of Ancient Indian history. In addition, the chapter considers alternative explanations for certain *sreni* features.

Although these features developed over a fairly long period of time (800 B.C.E. to 1000 C.E.), a quick glance at Table 2.1 indicates that the *sreni* possessed many of the features of more recent OE such as corporations or guilds (e.g., separate entity status, entity shielding, liability insulation, binding internal governance rules) (Thrupp 1963, Thaplyal 1996). Indeed, it is difficult to compare the *sreni* to entities in its own timeframe in other places because the *sreni* predates the Roman proto-corporations by centuries and is considerably more complex and detailed than them (Hansmann et al 2006). Moreover, even when comparing the *sreni* to more modern entities the fit remains difficult. For example, when comparing to Medieval European guilds (Kieser 1989, Grief, Milgrom and Weingast 1994), the *sreni* did not have to be dedicated to a single profession, were mobile (e.g., moving location even without a threat of military action) and were used in non-economic activity as well (Majumdar 1922, Thaplyal 1996).[2] On the other hand, compared to US corporations, there are many features that the *sreni* did

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[2] Although mobility was possible, some authors suggest it would require state acquiescence. See Thapar (1997)

Table 2.1 Summary of characteristics of the sreni

Characteristics	*Present in Ancient Indian* sreni*?*
Separate entity	Yes
Centralized management (headman and officers)	Yes
Entity shielding/asset partitioning	Yes
Transferability	Perhaps
Limited liability of shareholders	Probably not
Agent can bind entity	Yes
Management elected	Probably Yes (at times appears hereditary)
Management can be removed	Yes
Duty of loyalty	Probably Yes
Duty of care	Probably Yes
Liability insulation for management	Yes (though not detailed)
Screens on member suits and internal enforcement	Yes (though not detailed)
Binding internal governance rules (*sreni dharma*)	Yes
Some reimbursement for legal defence	Yes
Easy formation	Yes
Register with state	Yes
State approval needed	Yes
Use of incentive payments	Yes (though not detailed)
Easy entry	Some conditions, but no caste bars
Sharing of assets and liabilities	Terms of agreement and additional rules
Easy exit	Yes, but with obligations potentially
Board/committee independence	Probably Yes
Other board qualifications	Yes (though not detailed)
Open debate in meetings and shareholder resolutions	Yes, with limits (though not detailed)
Transparency and disclosure valuable and encouraged	Probably Yes (though not detailed)
Range of activities engaged in is broad	Yes – at peak ~150 professions (e.g., silk weaving, pottery, banking, others) – at times multiple professions in one *sreni*.

not possess (e.g., there is little evidence to suggest that: (i) the *sreni* had many, if any, passive investors or that the primary purpose of the *sreni* was to raise capital from passive investors; or (ii) the *sreni* possessed detailed disclosure rules, proxy rules or private class actions) (Clark 1986, Allen and Kraakman 2016).

In light of this, one area of interest is exploring how many of the concerns animating some regulation in the US appear to have been known during the time of the *sreni* and how attempts were made to address them in some, however rudimentary, fashion. This suggests that the Ancient Indians gave considerable thought to agency costs and incentive effects. Such a sophisticated and developed organizational structure raises a number of important issues meriting closer examination.

To engage in this examination I divide the history of Ancient India into various time frames (Parts IV–VIII) that aid us in examining what economic, political and social factors influenced the development of business entities. This approach allows us to view the development of the *sreni* over time and to examine when certain features developed and in what context. With these thoughts in mind let us begin our journey.

IV. THE ORIGIN OF THE *SRENI* – PRE-MAURYAN INDIA

The origin of the *sreni* is shrouded in the mists of Ancient Indian history. Although there is substantial excavational and other evidence of active trade and economic activity in the Indian Subcontinent dating back to somewhere between 6500 B.C.E. and 5000 B.C.E.,[3] the sources do not

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[3] See Jarriage (1993), Kenoyer (1998), Jarriage and Meadow (1980), Kenoyer (1997), Chakrabarti (1990). Excavations in the Indus area (circa 3300 B.C.E. to 1900 B.C.E) suggest a resource-rich, fertile and heavily populated area that was considerably larger than its contemporaries (e.g., Egypt and Mesopotamia). *See* Thaplyal (1996), Kenoyer (1998). There are no large centralized structures attesting to great kings or ritual centres (which we witness in other civilizations). Moreover, there is little evidence in most sites of armed conflict or massacres. *See* Kennedy (1995), Dales (1964), Kenoyer (1998). We may learn more about the Indus area civilizations once the Indus script is deciphered or the seals commonly found in the area are deciphered. *See* Kenoyer (1998). For discussion of civilization in the Indo-Gangetic region (circa 1900 B.C.E. to 800 B.C.E.) see Erdosy (1995), Allchin and Allchin (1997), Das (1980).

mention the *sreni* until around 800 B.C.E.[4] Further, these sources provide us with only a few details about the organization and operation of the *sreni*.[5]

More details emerge with the arrival of the Buddha and the growth in Jainism at the dawn of the 6th century B.C.E. Apart from the religious and political significance of the increasing presence of these two great world religions, trade and OE were significantly impacted. Neither religion stressed caste divisions and they both appeared to permit easier interchange among groups in society, which further helped to expand trade, innovation, and production (Bose 1961, Thaplyal 1996, Adhya 1966).[6] On the technological side, the greater use of iron at this time would have helped in constructing tools to enhance the development of agriculture (e.g., iron ploughs, axes) and crafts, and improve transportation and storage (Thaplyal 1996). In addition, there was significant urbanization (a trend continuing from earlier times) and the use of coins as currency was quite common thereby making transactions easier (Thaplyal 1996, Agrawala 2004). All these factors contributed to the rise in trade and the demand for collective efforts and organizational forms.

Monitoring of group members was facilitated because the professions tended to be localized in specific parts of towns and cities (as in earlier times) (Agrawala 2004, Das 1980). This not only made it easier to monitor people – geographical proximity enhances monitoring for breaches of duty and facilitates the imposition of reputational penalties – but also likely enhanced productivity because proximity might improve group cohesion and make training of new recruits somewhat easier (Grief 1993, Klein and Leffler 1981, Bernstein 1992, 2001, Ellickson 1985, Charny 1990). Further, by this stage accounting was a recognized profession, which would have helped in policing the boundary between entity and owner assets (Agrawala 2004, Das 1980, Sharma 1987, Agrawala 1987). All the basics were then in place for organizational entities.

Indeed, written sources attest to the presence and importance of the *sreni* by this time (Thaplyal 1996, Das 1980, Sharma 1987). The *sreni*

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[4] See Madhavananda (1953), Majumdar (1922), Thaplyal (1996). There is debate on the dating of sources before the 7th century B.C.E. and thus I rely on dates that seem to have some common acceptance. *See* Thapylal (1996), Mookerji (1959). Dating materials after the 7th century B.C. seems less problematic. See, e.g., McCrindle (1960), Giles (1923), Watters, (1961).

[5] See Roy (1884).

[6] Buddhism seemed more supportive of the *vaishya* (roughly, mercantile) caste compared to Hinduism (Das 1980).

was clearly a separate legal entity and could hold property separately from its owners, construct its own rules for governing the behaviour of its members, and contract, sue and be sued in its own name.[7] The *sreni* were in varied fields (roughly 18–27 professions), actively involved in trading, production, basic banking, and other services and could be mobile from one place to another without changing their obligations to other parties (Majumdar 1922, Rouse 1901, Sharma 1987, Mookerji 1958). However, there is little evidence at this point about whether entity shielding existed at law.

There is evidence of *sreni* with a headman (*Jetthaka* or *Sreshthi*) who represented the interests of the *sreni* in the king's court and elsewhere, could bind *sreni* in contracts, set conditions of work within the *sreni* and was the overall administrative authority within the *sreni* (Mookerji 1958, Majumdar 1922, Chalmers 1895, Jolly 1956). The presence of a headman is not that surprising because some *sreni* were quite large (e.g., over 1000 members) and decentralized decision-making on operational matters could have been very challenging (Franics and Neil 1897, Thaplyal 1996).[8] It also seems the headman was normally elected by the members of the *sreni*, but there are instances where the position passed down to the son of the headman if the headman died in office (Rouse 1901).

Finally, we have the first indications that the customs, traditions and usages of the *sreni* (*sreni dharma* or internal governance) were written down and the sources suggest that these were treated as recommendations to the king that he should enforce these rules, absent them being against royal interest or scripture (Buhler 1965). We do not, however, have references to what was contained in the *sreni dharma* or any further materials on *sreni* formation, staffing or funding.

V. THE MAURYAN EMPIRE

The next major change in India was the rise of the Mauryan Empire (*circa* 320 B.C.E. to 185 B.C.E.).[9] Although the empire lasted for only about 135 years, it covered virtually all of modern day India, Pakistan,

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[7] See Mandlik (1982), Buhler (1886), Kangle (1972).

[8] The headman was often experienced, skilled, intelligent, and sometimes already quite wealthy. See Rouse (1895, 1901), Chalmers (1895), Francis and Neil (1897).

[9] The Mauryan Empire arose almost contemporaneously with the invasions of Alexander the Great (and might be seen as a response to it). See Mookerji (1966), Thapar (1997).

Bangladesh and Afghanistan and its development brought changes that would reverberate for many years to come. Three changes merit specific mention.

First, with so much of the Subcontinent under one ruler, the trade routes in India became more secure thereby reducing the risk associated with the transportation of goods.[10] This was accompanied by improved infrastructure, greater uniformity in measurements, and increased use of coinage – all leading to greater trade (Gokhale 1977). Second, Buddhism became more important when Ashoka (the third Mauryan Emperor) adopted the Buddhist faith (Thapar 1997, Bhandarkar 1956).[11] This facilitated the growth of a religion that likely favoured expanded trade as noted earlier. Third, was the publication, *circa* 300 B.C.E. to 275 B.C.E., of one of the most important ancient texts on economics, politics and administration – the *Arthasastra* (roughly, the knowledge, or science, of material gain).[12] It appears to have been the basis for the administration of the Mauryan Empire and indeed of many later (and smaller) empires in India for a very long time. Its influence can hardly be overstated and because of that I spend a little more time on it here.

The authorship of the *Arthasastra* is usually attributed to Chanakya who was the chief adviser and prime minister to the first Mauryan Emperor (Chandragupta Maurya) and helped him unify the bickering North Indian kingdoms into an empire.[13] In the *Arthasastra* the central state authority plays a critical role in many aspects of life and most importantly in commercial activity and politics. Although the private sector, including the *sreni*, was active, it was tightly regulated.[14] Chanakya appeared suspicious of the *sreni*.[15] He was generally concerned with any entity that had many members, good resources and a strong

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[10] The empire spent considerable resources building and maintaining roads throughout India with some sources noting that there were 15 types of roads. See Mookerji (1966). Ashoka also planted trees along the trade routes to provide travellers with places to rest and receive shade. See Thapar (1997).

[11] Ashoka spread Buddhism all the way to Afghanistan and encouraged people in Egypt, South-east Asia, and China to adopt the faith. *See* Thapar (1997), Bhandarkar (1956).

[12] There are a number of translations of the *Arthasastra*. I rely on Kangle (1972). Another excellent translation is Rangarajan (1992).

[13] See Kangle (1972). Chanakya was also called Kautilya.

[14] See Mookerji (1966). Mauryan India was engaged in large-scale commodity production. See Kosambi, (1982).

[15] See Kangle (1972) at 4.1–4.2 (referring to artisans and merchants as 'thorns' in Sanskrit).

sense of group loyalty as the *sreni* did.[16] He might have viewed them as potential threats to the cohesion of the recently formed empire.[17] However, the *sreni* could not simply be outlawed because they existed before the Mauryans and their support was probably necessary to increase the chances of unity in the empire. Moreover, Chanakya was cognizant of the importance of economic prosperity to maintaining the support of the citizenry and the *sreni* were the engines of economic growth.[18] Thus, regulating the *sreni* was a matter of balance for Chanakya – their support was needed, but they could not be permitted to destabilize the empire and hence they needed to be watched carefully.

In light of this, there were administrative officials whose task it was to superintend the various industries and professions represented by the *sreni* (Kangle 1972).[19] This was done through regular detailed administrative processes, but also through the use of spies and assassins. The regulation could be quite minute and encompassed the price of products or services, quality control, and even pay for *sreni* headmen. However, there is also evidence that the *Arthasastra* encouraged *sreni* to be active participants in the credit markets (where they provided loans, letter of credit services, and received deposits) as well as providing concessions to *sreni* in suits involving other *sreni* (Kangle 1972). Maintaining this balance seemed an important consideration.

Indeed, the *sreni* appeared to play a significant role in the high economic growth of the Mauryan Empire (Thapar 1997). For example, in addition to the *sreni* being a separate legal entity we have some hints that entity shielding was present. In the *Arthasastra* there is no mention of an entity – like a *sreni* – being liable for the personal non-*sreni*-related debts of its members, although there is extensive discussion of which family members may be liable for a relation's debts (Kangle 1972, Chatterjee 1971). Of course, the absence of reference to *sreni* liability for *sreni* members debts cannot be taken as hard proof of entity shielding, but it is perhaps indicative of it given the lack of reference to *sreni* liability in the

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[16] See ibid.

[17] For Chanakya unity was important to keep invaders (e.g., Greeks) out of India and anything that impeded this unity would have been looked upon with suspicion. See Kangle (1972).

[18] See Kangle (1972), Mookerji (1966), Agrawala (2004).

[19] There were at least 30 (or more) areas that were being superintended and kept detailed records on rainfall, crops, mines and so forth. See Mookerji (1966), Kangle (1972).

context of a detailed discussion of who else could be liable for a debtor's debts.[20]

Further, there is detailed discussion of accounting in the *Arthasastra*. Chanakya required the keeping of detailed accounts for tax purposes, frequent auditing to prevent and deter fraud and corruption, and fairly specific accounting treatment for many items (e.g., costs were divided into fixed and variable and there were rules on different sources of profit) (Kangle 1972, Mattessich 1998, Sihag 2004).[21] Finally, although there is little discussion of how bankruptcy may have operated, there were simple and clear rules about debt obligations and when a debt would cease to be enforceable as well as rules on pledges and deposits to secure loans (a form of security or collateral) (Kangle 1972). With this background one is not surprised to see trade growing and *sreni* being active.

There is also evidence on the internal governance of the *sreni*. The king was now *expected* to respect *sreni dharma* (as compared to following *sreni dharma* being a recommendation).[22] This suggests that *sreni* had become significant enough that kings paid heed to *sreni dharma* (even recording them for later use in disputes). This also indicates that rules of governance need not be exclusively mandated from the state, but could be devised voluntarily by the entity.[23]

Discussion of *sreni* headmen is also more detailed. For example, *sreni* members could punish or remove the headman, without the king's approval, for violation of *sreni dharma* and destruction of *sreni* property (Kangle 1972, Kane 1933, 1973). However, little detail is provided at this stage on how this process worked.

Finally, there are provisions regarding the exit of *sreni* members (which was clearly possible) and how they might be fined if they left after work on a project had commenced (Kangle 1972). For example, if

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[20] The only references to an entity being liable for the personal debts of its members were in the context of non-commercial Buddhist *sanghas* (a religious order usually of monks and nuns who renounced the world). *See* Rhys David (1901).

[21] There were *gopas* – village accountants/census takers – who would keep account of: (1) all real and personal property for wealth tax purposes; (2) each household's annual income and expenditure for income tax purposes; and (3) the number and types of merchants and artisans for sales tax and occupational licence tax purposes. See Kangle (1972). Mattessich (1998) considers the *Arthasastra* the first known treatise on accounting concepts.

[22] See Das (1980), Kangle (1972).

[23] See Kangle (1972). This is somewhat surprising given the more centralized nature of the Mauryan Empire, but such concessions may have been needed to maintain the support of the *sreni*.

someone contracts with the *sreni* assuming there would be 300 members working on a project for two months then if some people leave the *sreni* that might change the timeframe for completion or the likely quality of the product. If there were no way to police this then contracting parties might be reluctant to contract with the *sreni* (a concern seen in modern partnerships).[24] A sanction on leaving may assuage these concerns.

Thus, by this time the *sreni* had become an important part of Indian life and a number of its traits were already visible (although not all). However, the importance of the *sreni* would continue to grow over the next few centuries.

VI. POST-MAURYAN KINGDOMS

Following the decline of the Mauryans, India broke into a series of smaller (albeit still very important and rich) kingdoms (Adhya 1966, Jagannath 1957).[25] These smaller kingdoms presided over an impressive expansion of trade and many of them continued to rely on the *Arthasastra*. Of course, one might wonder how trade continued to grow in an environment that seemed the opposite to the Mauryan and what role, if any, did the *sreni* play in this growth.

The first thing to note is that India was not in a state of constant war and that many of the roads and trade routes continued to be used (Das 1980, Agrawala 2004). Moreover, sea trade (especially with the Romans) was growing and was quite safe and efficient (Agrawala 2004, Adhya 1966). Indeed, the growth in foreign sea trade may have more than compensated for the instability, at times, in domestic land trade.

Second, after the fall of the more centralized Mauryan state, the *sreni* were not held in as tight reign and could adapt more quickly to their environment (Thaplyal 1996). The newly unshackled *sreni* grew quickly and established their sway over much of India (Das 1980, Adhya 1966). Moreover, kings were quite keen to have the favour of the *sreni*, no doubt to help stabilize or cement their control over a region.[26] This environment was well suited to the growth of the *sreni*. There were now many more

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[24] *See* Allen and Kraakman (2016).

[25] North and South India were not unified again until the Mughal empire in Medieval India around the 15th century C.E. Trade with Rome was so substantial that Roman Senators are known to have complained about it and to sometimes have enacted laws restricting it. See Das (1980).

[26] See Das (1980), Adhya (1966).

sreni (representing at least 74 occupations) and they took a more active role in other aspects of Indian life (e.g., judicial, banking) (Adhya 1966).

The increasing importance of the *sreni* led to greater discussion and writings about it. As before, the *sreni* were separate legal entities, but now we have clearer references to entity shielding. The materials indicate that a creditor cannot attach the assets of other people or entities associated with the debtor unless the debtor took the debt acting as an agent for these other people or entities (i.e., the debt was not personal).[27] When this is combined with detailed accounting rules, the environment appears quite favourable to organizational entities.

Further, kings are still expected to maintain *sreni dharma*,[28] and we have details on the penalties that might be imposed for its violation. For example, embezzling from the *sreni* was considered an offence as was a *sreni* member keeping *sreni* property for himself (with a penalty 11 times the value of the property).[29]

The large fines and increasing role of state enforcement of *sreni dharma* seems connected to the growth of the *sreni*. For example, it would be difficult for the *sreni*, or its members, to self-monitor such a large and asset-rich entity. This is due to a number of reasons. First, the likelihood of the *sreni* apprehending and sanctioning wayward members may decrease as the number of members increases. If the likelihood of apprehension drops then some supplementary measure (e.g., larger sanctions or an outside monitor) is needed to maintain deterrence, and legal sanctions and state enforcement can serve this role.[30] Second, as *sreni* became wealthier the gain to the member from engaging in misbehaviour increases – more assets in the *sreni* imply more to be gained from obtaining those assets. This may also call for resort to larger sanctions and tighter enforcement – something that outside legal enforcement could provide. Moreover, it is plausible that rulers who were keen to curry favour with the *sreni* (and obtain their support against other potential

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27 See Mandlik (1982), Buhler (1886), Mayne (1950). A potential exception is for religious fraternities that operate as communes – Buddhist *sanghas*. See Rhys David (1901).

28 See Mandlik (1982), Das (1980).

29 See Mandlik (1982). Borrowing funds on behalf of the sreni and using it for personal purposes was also an offence. See Kane (1933). The *Mahabharata* suggests *sreni dharma* violations are very serious. *See* Roy (1884).

30 As the probability of apprehension declines the expected sanctions drops and so does deterrence. Some measure (larger sanctions, more frequent enforcement) to counter this is then needed. See Becker (1968). However, the *sreni* may not have been able to generate a sanction large enough to achieve this, whilst the monarch might.

rulers) might be inclined to provide additional benefits to them (e.g., additional enforcement of *sreni dharma*).

In terms of personnel, we witness the first references to executive officers. One might treat the presence of the executive team as indicia that the *sreni* had become so large that one could not simply rely on the *sreni* headman to run the entity without assistance. Typically, there were two to five executive officers (*karya chintakah*) who could bind the *sreni* on *sreni*-related business (Jolly 1965a, Thaplyal 1996, Mandlik 1982). The executive officers were generally elected by the *sreni* assembly (the *sreni* members voting on a matter) and could be removed by them (Jolly 1965a, Majumdar 1922).

Finally, we have some discussion of how *sreni* profits, assets and liabilities might be shared (Jolly 1965b, Mandlik 1982, Altekar 1957). Some sources suggest sharing based on the amount of capital contributed to the *sreni* by the member or perhaps on capital and skill provided (Mandlik 1982, Jolly 1965a, 1965b). There were also rules governing the profits members might receive. For example, if a member acted against the advice of other members and caused loss then that member would bear the whole loss, while if that activity turned a profit that member would receive an additional one-tenth of that profit amount as his reward (Mandlik 1982, Jolly 1965a). These more varied sharing approaches indicate the increasing importance of *sreni* and how they were used in differing contexts that might merit a variety of approaches to profit and asset sharing.

VII. THE GUPTA EMPIRE AND INDIA'S 'GOLDEN AGE'

Some of the post-Mauryan kingdoms were partially united in the 3rd century C.E. with the advent of the Gupta Empire (*circa* 240 C.E. until 550 C.E.), which is usually referred to as India's 'Golden Age' (Mookerji 1959, Khandalavala 1991, Raychaudhuri 1997). Much like the Mauryan Empire, the Gupta Empire had a number of long-range implications for India that were associated with an increase in the number and importance of the *sreni*.

The first was that, although the Guptas relied on many of the *Arthasastra's* principles, they were not nearly as centralized as the Mauryans (Mookerji 1959, Thaplyal 1996). Rather the Gupta Empire was a looser confederation of kingdoms relying more on tributes, strategic alliances, and greater decentralization. The significance of this for trade was that the central authority did not regulate economic activity as tightly

as the Mauryans, yet it provided quite efficient administration, maintained safe trade routes, and encouraged trade (Thaplyal 1996, Das 1980). The Guptas' lighter regulatory hand can be seen in their use of coins. Generally, they did not change the currency in a conquered region, but would put an imprint of the Gupta Empire on one side and leave the other side with the pre-existing image (Thaplyal 1996). This is analogous to the Euro coins, which on one side indicate the country that minted them and on the other provide some depiction of the European Union.[31]

Second, the Guptas were quite active in building contacts with other countries (Mookerji 1959, Das 1980). These contacts bolstered the increasing and active trade with the Far East and South-east Asia when the Roman Empire, and trade with it, was weakening.

Third, a number of scientific and technological developments made Indian products more attractive. For example, the increasing use of the Indian numeral system and the development of zero as a placeholder would have enhanced trade by simplifying calculations and the overall transactional process (Paramhans 1957). Further, the use and development of iron in India at this time reached the highest levels. This would also have been displayed in more efficient tools for trade, transportation and storage (Das 1980, Mookerji 1959).

The *sreni* were, as before, separate legal entities with entity shielding, but now represented around 150 professions (Jolly 1965a, Jolly 1965b, Kane 1973, Thaplyal 1996). Indeed, the king was almost bound to enforce *sreni dharma*, which indicates how important the *sreni* had become. Although, at present, we do not have the written *sreni dharma* from this time, it appears that many ancient scholars encouraged (and some required) that *sreni dharma* be written down in a document (often called the *sthitipatra*) and registered with the state – probably for later use.[32] We also witness *sreni* being mobile, and willing to move to new locations to take up attractive new opportunities, as well as multi-profession *sreni* (e.g., bankers and artisans working together as well as silk weavers and archers) (Thaplyal 1996). Given the quick and high economic growth during this period, it is perhaps not surprising that the *sreni* were willing to meet the demand for additional occupations

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[31] Another example is where the Gupta emperors provided favourable treatment to *sreni* which relocated their operations to a region where the Guptas were trying to generate economic growth. See Thaplyal (1996).

[32] Davis (2005) notes that even in later time periods (e.g., 12th century C.E.) the internal rules of certain groups and their role in the hierarchy of laws and rules were important.

(Mookerji 1959, Thaplyal 1996).[33] The *sreni* might be willing to move to new locations for the same reasons too (as well as other reasons). These features are consistent with the *sreni* being a critical factor in exploiting the opportunities for economic growth in the Gupta Empire. Indeed, this may have been one of the key reasons why there is such detailed information on the *sreni*. Given the amount of material I divide the discussion into two sections – the first on *sreni dharma* and the second on *sreni* formation and funding.

A. The Development and Enforcement of *Sreni Dharma*

Sreni dharma was usually the result of discussion and debate within the *sreni* general assembly (Thaplyal 1996, Kane 1933). If a *sreni* member violated *sreni dharma* the headman or the executive officers could impose a penalty on that member (Jolly 1965a).

A member dissatisfied with the result had, it appears, two methods of redress. First, the member could appeal to the *sreni* assembly and request them to overturn the decision and punish or remove the headman or officers (Kangle 1972, Kane 1933, 1973). If the assembly agreed and the headman or officer refused to follow the assembly's decision then the matter would be put forward to the king who would decide according to *sreni dharma* and impose increasingly severe punishments on the headman or officers (Jolly 1965a, Kane 1973).[34]

Second, the member could bring an appeal to the king (Jolly 1965a). If the king found the imposition of the penalty to be outside *sreni dharma* and motivated by ill will or malice towards the member then the punishment could be repealed. These procedures suggest a number of features worthy of further comment.

First, a king would normally interfere only when the *sreni* member could show ill will in the decision to punish the member (Jolly 1965a). The requirement of ill will serves to insulate the headman or officers from some liability (especially those who made honest mistakes of judgement not involving ill will). Absent such insulation the headman or officer may be reluctant to enforce *sreni dharma*. This is, one conjectures, because they receive only some of the benefit from enforcing *sreni dharma* and, if they bear liability without some insulation, most of the cost. The rule limiting royal interference may help to calibrate the

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[33] New products or services may develop that utilize some of the *sreni* members' skills and make it worthwhile to enter that field.

[34] The king's power extended to confiscating all of the headman's property and even banishment. See Jolly (1965a), Kane (1933).

cost-benefit calculation for the headman or officer in enforcing *sreni dharma*. This justification is analogous to the one given today for insulating directors from liability (e.g., via the business judgement rule) except for duty of loyalty violations, which are closer to ill will cases.[35]

Second, the assembly had the power to remove management. Although this appeared to require some cause (e.g., breach of *sreni dharma*) rather than just the choice of the members, the power to remove management did exist.[36]

Third, although sources do not provide explicit evidence on what *sreni dharma* usually said, there is some indicia of what might have been contained in them. For example, embezzling from the *sreni* was an offence (often remedied with a supra-compensatory penalty).[37] This suggests that the *sreni* was aware of conflicts of interest and severely penalized certain kinds of fraud. Second, an inscription from South India (from a little later than the Guptas) describes who can occupy important positions in municipal entities (Majumdar 1922). From those inscriptions it appears considerable thought is given to restraining conflicts of interest by prohibiting those with a conflict from serving in positions of importance. This bears some similarity to the independence requirement in more modern boards.[38]

Fourth, the method of enforcing *sreni dharma* bears some comment. When a matter was raised in front of the *sreni* assembly it would be discussed unless it was absurd or simply unreasonable in which case the member raising the issue would bear a penalty.[39] This acts as a constraint on frivolous usage of the assembly to address governance issues. Another example of attempting to screen out frivolous usage would be the ill-will requirement. This would screen out simple mistakes, which are more likely to be frivolous than ill-will cases.

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[35] See Clark (1986), Allen and Kraakman (2016), Klein, Ramseyer and Bainbridge (2015).

[36] See ibid

[37] See Mandlik (1982). Borrowing funds on behalf of the *sreni* and using it for personal purposes was also an offence. See Kane (1933), Mandlik (1982).

[38] See NYSE (2017), *available at* http://nysemanual.nyse.com/LCM/Sections/. Moreover, one might view some of the qualifications for headmen and officers as serving a similar function, but not in as detailed a manner as in the municipal entities. See Mandlik (1982), Jolly (1965a).

[39] See Kane (1933).

B. The Formation and Funding of *Sreni*

To form a *sreni* the members needed to establish it with some basic elements (e.g., *sreni dharma)* and then have it approved by the monarch and register the *sreni dharma* with the state (Sarkar 1975, Kangle 1972).[40] Of course, setting up the entity is only the first step – the real work comes in keeping the *sreni* profitable and in building up membership.

Entry of new members followed two steps (Jolly 1965a). First, the prospective member would need to build mutual confidence with pre-existing members. There were multiple ways in which this could be accomplished such as via an 'ordeal' (*kosha*), or agreeing to *sreni dharma* (*lekha-kriya*), or having a person of high standing vouch for a new member (*madhyastha*) (Jolly 1965a, 1965b). Second, once mutual confidence was established, the admission of a new member was normally put to a vote of the *sreni* assembly and if successful the member would immediately share all the assets and liabilities with other members (Kane 1973).

Of course, the *sreni* was not necessarily a life-long commitment. A person could leave the *sreni* without the assembly's approval and upon exit the member would no longer have any claim to the assets or liabilities of the *sreni* (Majumdar 1922, Kane 1933). However, it was possible for the exit to have additional consequences. For example, if a member left the *sreni* after work had been commenced on a project the member was part of then it appears that person could be fined (Kangle 1972).[41]

One more point is noteworthy. In Ancient India the caste system was quite important (Jaiswal 1986, Dass and Deulkar 2002). What makes the *sreni* so unique is that it permitted people from different castes to enter and practice the same profession *and* to leave the *sreni* of their own volition and enter different *sreni* if they wanted. The degree of labour mobility suggested by the procedure for entry and exit into a *sreni* stands in marked contrast to the generally perceived rigidity of the caste system (Thapar 1997, Pandey 1986).

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[40] Monarchs could refuse to approve combinations of *sreni*. See Jolly (1965b). It seems reasonable to assume that the grounds for doing this are similar to the grounds for refusing to approve the creation of a *sreni*.

[41] Moreover, if a member was removed from the *sreni* (for, say, the violation of *sreni dharma*) then that probably made it more difficult for a person to enter another *sreni* given the likely reputational consequences. See Thaplyal (1996).

The sources of *sreni* funding came from many places, but were treated as belonging to the entire *sreni* rather than specific members (Kane 1933, Jolly 1965a). These included the individual contributions made by members to join the *sreni*, the gifts given by the monarch to various members of the *sreni* for the *sreni*, the profits from completed projects, the profits earned on other activities (e.g., banking), and the penalties recovered from *sreni* members when they violated *sreni dharma* (Kane 1933, Jolly 1965a, Thaplyal 1996).[42] However, there were other costs that are significant from a governance perspective.

First, *sreni* often kept funds for defending their members against legal action. Examples include *sreni* arranging bail for members (Thaplyal 1996). This bears some resemblance to modern corporations indemnifying the legal expenses of directors and officers.[43] Second, *sreni* funds could be expended to provide additional incentives to its members. There are instances of *sreni* rewarding members who protected *sreni* property against robbers and thieves on trade caravans (Jolly 1965a).

Once we have taken account of the assets and liabilities the issue arises as to how the entitlements of the *sreni* members in these assets and liabilities were determined. As in post-Mauryan times there were a variety of sharing formulae including equal sharing, sharing based on capital contribution or skill, or some combination (Kane 1933, Jolly 1965a, 1965b, Mandlik 1982).

Finally, we have significant evidence for the other roles the *sreni* occupied in society. The *sreni* often acted as a bank for its members, and later non-members, and generally had an excellent reputation for reliability and stability (Thaplyal 1996). For example, they sometimes minted coins used in commercial transactions and often received deposits (usually perpetual endowments) from people, including monarchs and high officials, where the interest earned was used primarily for charitable and religious purposes. Additionally, *sreni* provided loans for a variety of projects and made sizeable profits from the interest (Thaplyal 1996).

However, *sreni* were active in other aspects of life besides trade. Many *sreni* engaged in acts to support charity and religious institutions and some took on adjudicative tasks not involving their members (often

[42] *Sreni* assets were utilized for the costs of producing goods for sale (for craft *sreni*), purchasing goods for later resale (for merchant *sreni*), transporting and protecting goods during travel (e.g., hiring guards), and the expenses associated with running a *sreni*. See Jolly 1965b.

[43] *See* Clark (1986), Allen and Kraakman (2016), Klein et al (2004).

commercial matters that reached the king's court (Thaplyal 1996, Majumdar 1922, Jolly 1965a).[44]

VIII. POST-GUPTA

After the fall of the Guptas, trade declined and India's smaller kingdoms began a period of internecine warfare. Except for a short period (the reign of Harsha Vardhana 606 C.E. to 647 C.E.), the post-Gupta era was characterized by frequent wars and on-going political instability, which increased the risk of longer distance trade.[45] Also, in these conditions, many *sreni* members were forced to move around thereby impeding the cohesion needed for effective functioning of the *sreni* as well as making it harder to plan out projects leading to the *sreni* becoming less prominent (Thaplyal 1996). Indeed, to make matters worse, the *sreni* appeared to become castes in themselves and entry into them hardened (perhaps as a response to the underlying instability), depriving the *sreni* of a broad base of talent. For all intents and purposes the *sreni* were no longer a significant force.

The written evidence on the *sreni* during this period is similar to that during the Gupta times, but there is a little more detail on the possibility of transferability of interest and also on the governance of non-economic organizational entities, such as municipal and village entities, which may provide insights on economic entities (Majumdar 1922, Das 1980).[46]

It appeared possible for members of a municipal entity (like a village) – akin to *sreni* in many ways – to sell or transfer their stakes in the entity. Inscriptional evidence suggests that it was fairly common for this to occur either by outright sale or by inheritance (Majumdar 1922). It also appears that villages could combine by agreement of their voting

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[44] Note, however, that *sreni* management could not simply spend *sreni* resources on whatever they liked. The expenditure could not be contrary to *sreni dharma*. *See* Mandlik (1982). Further, *sreni* courts were subject to procedural rules similar to other courts and were usually set up in the locale of the dispute. See Jolly (1965a).

[45] For greater discussion of Harsha's reign see Cowell and Thomas (1968), Goyal (1992), and Watters (1961). For discussion on some of the successor kingdoms to the Guptas see Maitreya (1987), Puri (1986), Seth (1978) and Thaplyal (1996).

[46] The entities went by a variety of names – *gana, samgha, sabha, sreni*, and others too. See Majumdar (1922).

assemblies.[47] Although it is quite likely that this may have been done to block an invading force (like a treaty) or to provide a broader base of support during a famine, nonetheless such combinations were possible (Jolly 1965b). Moreover, some evidence exists to suggest that combinations of *sreni* required the approval of the monarch, which implies that such combinations could occur too (Jolly 1965b).

What this means for the transference of interests in commercial *sreni* is difficult to discern with the available evidence. The presence of such combinations suggests that it was possible for one entity to acquire interests in another, but that does not mean *transferability* per se – it could simply mean more members were added to a particular *sreni* or municipal entity thereby effecting an 'acquisition' of sorts. This could happen without one member having the right to 'sell' shares to someone else because new members might be added without requiring existing members to sell or transfer their shares.[48] However, there is little evidence on which we can rely to determine this and little evidence of a functioning market to sell *sreni* interests.

Aside from transferability, the inscriptional evidence provides descriptions of how municipal entities were run. They were operated in a similar manner to *sreni* – assembly voting mattered, open discussion was important, people felt bound by assembly decisions, yet much of the village work was run by elaborate specialized committees (e.g., annual supervision committee, garden supervision committee) (Majumdar 1922).[49] Further, the selection of committee members reflects interests in having competent and motivated members (as in the commercial *sreni*),[50]

[47] See ibid., (quoting from the Tamil endorsement on the Udayendiram plates of Nandivarman (roughly 10th century C.E.) which states 'we, (the members of) the assembly of Kanchivayil and we (the members of) the assembly of Udaya-chandra-mangalam (have agreed as follows): – we, (the inhabitants of) these two villages, having joined (and) having become one, shall prosper as one village from this (date)').

[48] Given the method of being admitted to the *sreni* (by vote of the members) one suspects transferring one's interest might require the same kind of vote or approval. Moreover, the municipal entity 'shares' might have been tied to owning land in that area in which case these 'shares' are just attached to real property and transferable perhaps only with that property.

[49] Many municipal entities had the power to levy taxes and regulate the price of commodities within their realm (Majumdar 1922).

[50] Individuals who failed to submit accounts from their last stints as committee members (and those who violated certain rules) were not qualified to sit on committees. Further, candidates for committees must own land or alternatively own a minimal amount of land but be well versed in scripture.

as well as considerable attention to preventing voting fraud in the selection of these members. On the latter, substantial effort was put forward to make voting visible to the assembly (Majumdar 1922). This often involved having a young child pull 'tickets' with names of candidates from a pot (presumably because the child is unlikely to behave fraudulently) and then having a series of respected villagers (e.g., priests and others) read out loud the contents of the ticket to the village assembly (presumably to address concerns about fraud or corruption). Although the materials do not provide evidence on these processes in commercial *sreni*, these procedures in municipal entities suggests considerable attention to these concerns.

IX. *SRENI* POST-MORTEM?

As noted above, the *sreni* began a long and slow decline from around 700 C.E. onwards. This was also a period of considerable political and economic instability that further weakened the *sreni*. However, this did not mean that economic activity came to a standstill or that the Subcontinent fell into disrepair until the BEIC arrived. Instead, after some period of decline, the Subcontinent rebounded and was again a key contributor to the global economy (Maddison 2006, Tomlinson 2003). In separate research I am exploring what business forms were active during this period where there were both large empires (e.g., the Mughals) and smaller multi-regional kingdoms, but substantial economic activity (Khanna 2017).

The version of Islamic law that the Mughals and Sultanates utilized did not appear to allow for commercial entities like the *sreni* (Kuran and Singh 2013, Bayly 1983), but it might have been possible for the spirit of the *sreni* to animate business behaviour indirectly and perhaps directly. For example, because most business was conducted in equivalents to the sole proprietor, partnership and family business models the scale of most business was small and tied closely to the personal attributes of the individuals involved, especially their castes (Bayly 1983, Moreland 1920). Given that many of the *sreni* had become castes it was not surprising that economic activity often continued in these castes, but at a smaller scale than with the *sreni*. Nonetheless, this suggests that *sreni*

These requirements may work to bring in expertise and people who have more at stake in the village to run committees. See Majumdar (1922).

governance probably continued to have an impact on business operations in India – via caste norms – even after the *sreni* were no more.

However, some evidence suggests that just before the arrival of the BEIC and the rise of the British Raj, the *sreni* (or remnants of it) may have been in the process of reconstituting in some form. Although Mughal Islamic Law did not allow for large commercial entities, it did allow for state-owned or state-run workshops or factories. There is considerable evidence of such workshops or factories – typically called *karkhanas* – throughout much of the Mughal period and even before (Moreland 1920, Bayly 1983, Chicherov 1971, Verma 1994). These entities dominated large-scale production (often of luxury items), but were not commercial entities like the *sreni*. However, evidence exists that by sometime in the early 17th century Mughal rulers began to tolerate private *karkhanas* owned by lesser nobles and by the late 17th century even tolerated private investment into *karkhanas* with accompanying profit-sharing rules and so forth (Moreland 1920, Bayly 1983, Chicherov 1971, Verma 1994). Most of the parties who appeared to take part in this private investment were Hindu castes that had been active in trade for quite some time. Indeed, some of these caste groups look like remnants of the *sreni.* Thus, near the arrival of the BEIC economic activity in the Subcontinent reflected an amalgam of smaller-scale business enterprises (e.g., like partnerships), which bore some connections to the *sreni*, as well as larger-scale entities that were increasingly reflecting some remnants of the *sreni*.

Although still early, this suggests that the *sreni* continued to influence business in the Subcontinent long after its decline. Further inquiry into how this happened, what impact it had on Mughal institutions, and how it was organized and operationalized is merited and is being pursued in Khanna (2017).

X. SUMMARY AND COMMENTARY

The political, economic and social conditions surrounding the development of business entities in pre-BEIC India (such as the *sreni*) reveal a number of things important to understanding the development of organizational forms of business. Moreover, the analysis provides insights into issues of scholarly interest today.

First, the evidence suggests the *sreni* existed as early as the 8th century B.C.E. and lasted until around 1000 C.E. Although there may be other business entities in other contemporary civilizations, the antiquity and

longevity of the *sreni* suggest an entity of considerable historical and institutional importance meriting further analyses.[51]

Second, the *sreni* developed along the theoretical lines suggested in Part II. In particular, the *sreni* grew as trade expanded and as the supply of the monitoring methods needed for its development arose. These methods included good physical monitoring of *sreni* members (due to localized professions) likely reducing agency costs and good accounting rules and entity shielding likely reducing creditor information costs. Evidence of entity shielding in India is available from as early as the post-Mauryan era (*circa* 1st century B.C.E.) onwards, although there are inklings of it even earlier. This provides some support for the thesis advanced by Hansmann, Kraakman and Squire (2006) on the importance of entity shielding to the development of the firm in Europe, but from a different and considerably earlier timeframe. However, the available evidence does not provide much information on whether entity shielding was available for the earlier eras (e.g., before the 3rd century B.C.E.), which leaves us with little information about whether entity shielding was necessary for the early *sreni*.

Third, *sreni dharma* and the rules surrounding the *sreni* seem to have developed in ways consistent with economic factors. Examples discussed include the increasingly detailed rules of governance (e.g., rules for aggrieved members, sharing assets and liabilities, the presence of executive officers), the mobility of *sreni*, multi-profession *sreni*, the greater legal and regal respect – over time – accorded to *sreni dharma* and the greater legal enforcement of its terms (from recommendations to requirements) and many others. Moreover, *sreni dharma* and the rules surrounding *sreni* bear some similarity to modern corporate governance rules. This suggests that some matters of governance raise concerns that are similar over time when organizations grow to similar levels.

The evidence about the scope and growth of the *sreni* also raises a number of important points about other areas of scholarly inquiry that I only mention in passing in this chapter leaving more fulsome discussion for other work (Khanna 2006, 2017). For example, the consistency of *sreni dharma* (and other rules) with economic factors and the similarity to modern rules of corporate governance has interesting, although not entirely clear, implications for the convergence debate (i.e., will corporate

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[51] There is scholarship mentioning partnership-like entities in Mesopotamia and Babylon, though without a focus on institutional or legal perspectives. See Ratnagar (1981), Ratnagar (2003).

governance systems converge?).[52] Another matter raised by the relative uniformity over time of *sreni dharma* and associated laws is: how was this apparent uniformity achieved?[53] Was this by state fiat, common business practice, negotiation over time, or something else? Yet another topic of interest is whether studying the *sreni* may provide insights on an issue of importance to economic development: what is the role of the state in facilitating growth?[54] In Ancient India trade grew under a variety of government structures. There were apparently peaceful loose city state structures (Indus Area Civilizations), a more centralized empire structure (the Mauryans), a less peaceful structure of multiple kingdoms (the Post-Mauryan age), and a looser empire structure with many tributaries and alliances (the Guptas). A natural question is whether these structures are equally good at encouraging trade and growth of business enterprises, like the *sreni*. Another related question is: given the extensive foreign trade connections of Ancient India might there have been some exchange of ideas and structures in the business realm? After all, Ancient India and Rome were trading partners for centuries suggesting that there was opportunity for exchange of ideas on economic activity – if so, then to what extent did practices in one civilization influence those in another and vice versa? Finally, as hinted at in Khanna (2017), it is likely that the *sreni* have continued to impact business in the Subcontinent even after their decline. How that has happened and through what channels is a topic of considerable importance not only when one is thinking about Mughal era institutions, but also when exploring institutional change and path dependence.

XI. CONCLUSION

India is a country of considerable historical antiquity with a long and successful history of trade. For the researcher, this makes it an enviable environment in which to study the development of business organizations. The analysis in this chapter focuses on the *sreni* – an important organizational entity in Ancient India that was primarily engaged in

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[52] On convergence see Hansmann and Kraakman (2001), Bebchuk and Roe (1999), Gilson (2001).

[53] I use the term 'apparent' because to hold a stronger view would require viewing the actual *sreni dharma* of many *sreni*, but the *sreni dharma* do not generally seem to have survived the years.

[54] For a general overview and critique see Avinash Dixit, *Evaluating Recipes for Development Success*, on file with author.

business or economic activity. Moreover, evidence of the the *sreni* dates from around 800 B.C.E to 1000 C.E. suggesting an antiquity and longevity warranting greater scholarly analyses.

When we examine the details of the formation, governance and regulation of the *sreni* we find that its development corresponds well to more modern theories about the development of the firm. In particular, the *sreni* grew as trade expanded and as the supply of the monitoring methodologies needed for its development arose. Moreover, when the features of the *sreni* are compared to those of Anglo-American corporations we find some similarity. The members of the *sreni* faced some similar concerns to those we face today and found quite similar ways of addressing those concerns. This suggests attention to agency costs and incentives and a fairly sophisticated approach to business. Moreover, even after its decline the *sreni* appears to have continued to have an impact on business in India.

In addition to these findings, analysis of the *sreni* and its development might provide insights on a number of topics of scholarly interest. This might range from debates on the convergence of governance systems to the impact of legal structures on economic development to whether there was an exchange of ideas on business structures (and why or why not) between major ancient civilizations to how the *sreni* still impacts business in India centuries after its decline and what that tells us about institutional change.

Overall the ability of the *sreni* to survive and develop in a predictable fashion through so many centuries and such differing environments in Ancient India and beyond attests to its resilience and adaptability. One suspects much can be learned about organizational entities and the history of business from studying the *sreni.*

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3. Business organization and organizational innovation in late Medieval Italy

Yadira González de Lara[*]

1. INTRODUCTION

There is a growing consensus that business organization and organizational innovation are key determinants of economic growth and that business history is the most suitable arena for their study (e.g. Musacchio and Turner 2013; Morck and Yeung 2011; Greif 1996; Williamson 1982). The diversity of economic and legal environments and the multiplicity of contractual forms utilized throughout history may provide the variety required for evaluating the extent to which organizations impact economic progress and the generality of organizational theory (e.g. Nicholas 2015; Abramitzky et al. 2010; Hilt and O'Banion 2009; Guinnane et al. 2007; Hansmann et al 2006; Hilt 2006; Carlos and Nicholas 1990). Business history can also advance the analysis of organizational innovations by shedding light on the emergence of important contemporary organizational features and disentangling the effects of path dependence (e.g. Dari-Mattiaci et al. 2017; Martínez-Rodríguez 2016; Le Bris et al. 2015; Gelderblom et al. 2013; Harris 2010; Malmendier 2009; Greif 2006). The historical analysis of organizational development in late medieval Italy is of particular interest as the period (1050–1350) was one of continuous progress, innovation, and experimentation in business techniques and Italy, the birthplace of most of these advancements, dominated the trade of Southern and Western Europe because of this (Hunt and Murray 1999; Cipolla 1993[1976]; Lopez 1976; de Roover 1963). Furthermore, the new organizational forms that emerged in late medieval Italy and the institutions that supported them set European

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merchants on a distinctive path of economic development, which arguably explains why the Latin West rose to prominence in later centuries while the Middle East declined (Kuran 2011; Harris 2009; Greif 2006).

This chapter can hope neither to describe in full detail the evolving menu of organizational forms available to business people in late medieval Italy, a topic that has already been addressed by previous generations of scholars (e.g. de Roover 1963; Luzzatto 1954; Besta 1937; Cessi 1917), nor to provide a definite study of organizational innovation. It only aspires to enhance our comprehension of past organizations by subjecting them to the rigour of modern economic and legal theory, while utilizing the richness of history to clarify important theoretical points and to regain a sense of the historical contingency of organizational choices.

The chapter is structured in three sections according to the various forms of organization defined by medieval contracts and law. It first deals with a variety of notarized credit instruments in the shape of short- and long-term loans, sales on credit, advance payments for future delivery, sea loans, and exchange contracts, from which the draft form of the bill of exchange and marine insurance emerged in the mid-fourteenth century. It then analyses the *commenda* contract, a new complex form of association that formalized agency and credit relations, thereby enabling both the provision of commercial services to handle a merchant's business abroad and the pooling of capital from disparate savers for investment in overseas commercial ventures. Finally, it examines the development of the *compagnia* as a modern form of partnership, featuring mutual agency, joint and several liability, and weak entity shielding, the emergence of the family firm as an essentially quasi-permanent ordinary partnership or *compagnia*, and the establishment of joint ventures in Venice and joint-stock companies in Genoa. A short conclusion follows.

2. A VARIETY OF CREDIT INSTRUMENTS

Medieval business credit was widespread (Usher 1943). Beyond consumption loans and public debt, the Italian notarial records show that credit transactions were an integral part of medieval production and trade. Local commercial borrowing was supported by straight loans and trade credit from suppliers and customers. For example, we know that in 1211 a shoemaker took a short-term loan in Genoa to buy nails and that a year earlier a prominent cloth dealer was a principal in 27 different sales credit notes ranging from just £3 to £240, for a total of over £2,300, Genoese currency, that is, for a total over ten times the price of a large

galley and more than 30 times the average yearly wage of a Genoese governor of colonial territories (Van Doosselaere 2009, 125–6, 136–7, 215). In 1239 a boat was sold on credit in Venice with a deferred payment of eight monthly installments and in 1197 four shares of a ship under construction to be delivered within six months were sold and fully paid in Aquileia (González de Lara 2000, 277). A distinctive form of credit, the *mutuo ad negociandum*, was developed in Venice to provide long-term financing for retail trade and local industry from various lenders. Initially, the lenders were entailed to half of the profit from their capital investments but over time they increasingly demanded a fixed rate of return, which was contractually determined according to the interest rate paid by a certain banking house or the cost of differed payment for goods sold by a certain craft workshop (Luzzatto 1958, 196–9; Luzzatto 1954, 75–9, 98–9; Cessi 1917, 42–8).

Straight loans, sales on credit and future delivery agreements were occasionally used also in maritime trade, but by far the most popular form of financing was initially the sea loan and then the *commenda* contract (González de Lara 2000, 279–82; de Roover 1963, 46–59, 65). The sea loan was a credit instrument used since antiquity to mobilize capital into risky investments in overseas trade and to protect the borrowing merchant against the perils of the sea and the action of hostile people. Like the ordinary loan, it entailed an interest charge, but it included a conditional clause that made the restitution of the loan contingent upon the safe completion of a voyage. The sea loan thus provided limited liability to the merchant against the risk of loss through shipwreck, piracy and seizure but, unlike today's standard debt contracts with bankruptcy, it placed all the commercial risk on the merchant. If the cargo arrived safe and sound to port, the debt was due in its entirety, regardless of the merchant's success or failure in earning enough to cover the high charges on the loan, which included both an interest rate and an insurance premium.

The contingency clause facilitated the mobilization of resources into overseas trade in various ways. First, it transferred the risk of loss at sea or at the hands of hostile people from the merchant to the investor, who was in a better position to diversify it by placing funds with multiple merchants. Diversification indeed was pervasive (González de Lara 2008, 253–5). Second, by exempting the merchant from his debt obligations in the likely event of shipwreck, piracy or mass confiscation of merchandise abroad, the sea loan assured a merchant that his properties on shore and his very person would not be legally seized for a debt that he very likely could have not repaid. If it had not been for this protection, it is unlikely that many merchants would have borrowed capital at all (Hoover 1926,

528–9). Third, even if a merchant had the temerity to raise capital through a straight loan, as indeed a few did, recovering a debt through legal proceedings beyond a venture's returns was a costly and sometimes unsuccessful endeavour. The merchant's limited liability for loss incurred while on voyage due to circumstances beyond his control thus enabled the contracting parties to save on enforcement costs, thereby making overseas trade more attractive to them (González de Lara 2017).

Yet, this clause created many opportunities and incentives for opportunism: a merchant could both pretend to have lost the cargo in the expectation of being released from repayment and assume excessive risks from which he was protected through limited liability. To mitigate the former problem, the Venetians, for example, stipulated that debt forgiveness because of misfortune at sea or at the hands of the enemy would occur only if this was 'clearly apparent' and required a merchant's claim for a waiver to be 'verified by reliable witnesses' (González de Lara 2011, 104–7). In Genoa, the drafting of the contract improved by inserting safeguards which prevented merchants from seizing upon any pretext to repudiate their debt: instead of conditioning repayment upon the 'safe arrival of the ship' on which the merchant voyaged, the sea loan was made repayable upon the 'safe arrival of the ship or most of its cargo' (de Roover 1963, 54, 56). An appropriate contractual design also mitigated the hazards of excessive risk taking by, for example, shipping merchandise on a cheap but unsafe vessel or changing route to a highly profitable but politically unsafe port. Sea loans everywhere in the Western Mediterranean typically specified the ship, destination, route, and sailing dates, and forbade the merchant from changing the ex ante terms of the contract, except for the explicit agreement between the majority of the merchants and the crew. By allocating control rights away from the merchant and toward a third party—the whole ship's company—with no or less conflicting interests with an investor, these stipulations restricted expropriation without severely constraining a venture's profitability. For example, in 1182, a group of Venetian merchants on a voyage to Constantinople on the ship commanded by the helmsman Simeone Istrigo came to know that the Pisans and the Genoese had been expelled from Byzantium and that their property had been seized. They then met with the helmsman and the crew and, on the basis of a majority vote, changed course to Alexandria (González de Lara 2011, 111).

The fixed-repayment schedule in the event of safe arrival, on the contrary, avoided the problem of diversion of profits from the investor by rendering a false commercial account and provided the merchant with the right incentives to refrain from both assuming excessive commercial risks and shrinking while doing business abroad. Yet, these advantages came at

the cost of forgoing mutually beneficial risk-sharing and facing high enforcement costs in case of default.

To reduce the cost of debt recovery, the Genoese, for example, secured repayment by a general lien on the merchant's entire asset base and that of his family and successors, and often attached a specific pledge to loan, either in the form of collateral or as a guarantee by a credit-worthy third party (van Doosselaere 2009, 137–9; Hoover 1926, 508–10). In Venice, however, a more effective administrative and legal system provided contract enforcement without requiring collateralization or personal surety and without holding the family legally responsible for a merchant's unpaid debts (González de Lara 2008, 261, 275). The threat of future exclusion from Venice's privileged trade and the garnishment of one-third of all his future income were sufficient guarantees of payment, even if the defaulting merchant was a relatively poor individual who had little collateral or he had pooled funds from many investors well beyond his own wealth to reduce the per-pound cost of his voyage. The cost of enforcing a debt contract in case of default was nonetheless significant: investors sometimes had to wait up 12 years to recover their loans and merchants ought to pay and actually paid a penalty for late payment of double the amount due plus a yearly charge of 20 per cent interest (González de Lara 2017, 7–8).

The sea loan remained in favour throughout the Middle Ages but progressively lost its popularity in favour of other contractual forms. Its declining prominence has been attributed to the rising doctrine against usury. Indeed, the sea loan was declared to be usurious in 1236 on the (correct) belief that it was regularly used as a subterfuge to disguise usurious loans rather than as a legitimate form of what we call today insurance. Yet, the papal bull *Naviganti* ruling that it was usurious was not binding on civil courts—which kept on enforcing sea loans after the ban, as well as many other contracts that were clearly sinful according to the teaching of the Church—and constituted but a mild censure—which was added as a late supplement to Gregory IX's more general condemnation of usury in the *Decretales* of 1234 and did not involve the denunciation by the whole Church, which would have required a Church council (Lane 1966; Luzzatto 1958; Noonan 1957). It would therefore be a mistake to ascribe the emergence of new contractual forms 'solely to religious influence' [Lopez 1976, 73]. In actual fact, the *cambium maritimum*—essentially a sea loan in which the funds advanced were repaid in another, instead of the same, currency, and hence the lender's gain, instead of being expressed in a percentage of the principal, could be hidden in the rate of exchange—was known long before it was generally adopted in the second half of the thirteenth century (van Doosselaere

2009, 133; de Roover 1969, 18; de Roover 1963, 55). Furthermore, the *commenda*—a better risk-sharing agreement under no suspicion of usury—had replaced the sea loan as the dominant form of business in maritime trade decades before the promulgation of the decretal *Naviganti* (van Doosselaere 2009, González de Lara 2008, Weber 2003 [1889]).

After the mid-fourteenth century credit and insurance began to be provided separately, through, mainly, informal bills of exchange, which, as the name indicates, served originally to implement a *cambium* or exchange contract—whereby an investor extended credit to a merchant in one place in one kind of money in return for an unconditional fixed payment in a different place in a different kind of money—and insurance policies—whereby an underwriter, who might or might not be funding a particular voyage, insured a shipment, generally for less than half of its value, in exchange for a premium payable in advance or, more generally, after the insured cargo was safely arrived to destination (Leonard 2016; Kingston 2013; van Doosselaere 2009, 182–207; de Roover 1963, 44, 67–9, 95). The combination of these two contracts enabled merchants to obtain higher protection against the risk of sea and people than through a sea loan or a *commenda* contract, both of which exempted the merchant from repayment beyond the amount that was retrieved from misfortune at sea or at the hands of hostile people but did not include a coverage payment to compensate him for his loss of gain in the event of shipwreck, piracy or seizure. This new allocation of risk, it has been argued, was optimal when overseas ventures lost many of its adventurous features and wealth accumulation from commerce reduced the former scarcity of capital (González de Lara 2009).

The medieval *cambium* or *instrumentum ex causa cambii* was an exchange contract in notarial form. It was initially used to finance the relatively less dangerous overland trade between the south of Europe and the fairs of Champagne and then to clear international payments (Face 1958; Reynolds 1931). In Genoa it was also used by foreign merchants in connection with the trading to a variety of inland towns, such as Rome, Verona, Milan, and Paris (van Doosselaere 2009, 132–3; de Roover 1969, 18–19). During the twelfth and thirteenth centuries *cambium* contracts were rare in maritime trade but occasionally occurred (González de Lara 2000, 278–9).

The *cambium* contract involved three operations, which were so closely interlocked that they could not be separated: it served to grant credit, to transfer funds, and to effect a currency exchange. The complex nature of the contract as a credit and transfer instrument is clearly manifested in a case in which circumstantial evidence reveals the intentions of the contracting parties. In 1320 the Venetian governor of

Trebizond, who had a surplus of funds to remit to his government, entered into a *cambium* contract with merchants with the declared purpose of remitting the funds to Venice without running the risk and the expenses of shipping specie, and while being paid. The merchants concluded the agreement as a means of financing a business venture with borrowed funds, for which they paid nearly 10 per cent interest (de Roover 1969, 21).

Like the *cambium maritimum*, the ordinary *cambium* could also be used to conceal the charge of interest in the exchange rate. It was even possible to cancel a first exchange transaction by re-exchange in the opposite direction with the purpose of covering up a regular loan, as in the case of dry exchange (de Roover 1969, 20–22; de Roover 1963, 67–8). The provision allowing for local reimbursement if the borrower was unable to pay abroad, though, did not always mask a fictitious exchange. In a great many cases, it constituted a realistic option for the borrower, as demonstrated by the very high exchange and re-exchange rates that these provisions quoted, the many mandates from lenders who instructed their proxies to recoup in foreign cities the proceeds of exchange contracts, and the numerous records of payment to foreign agents (van Doosselaere 2009, 134; Luzzatto 1958, 197–8). The *cambium* contract and its successor, the bill of exchange, in fact, remained perfectly legal credit instruments according to both cannon and civil law.

3. THE *COMMENDA*

Scholarly opinion is unanimous in recognizing that the Western *commenda* was 'a medieval innovation of the highest importance and [that it] contributed greatly to the fast growth of maritime trade' throughout the Mediterranean and beyond (Lopez 1976, 76). Yet, historians disagree on its juridical and economic nature. Some scholars view the *commenda* as a profit-sharing agreement or an equity investment, some as a partnership of labour and capital (Harris 2009; Pryor 1977; Udovitch 1962).

In essence, the *commenda* was a real contract whereby a travelling merchant acknowledged to have received from an investor a certain amount of cash or merchandise, with which he ought to go on a voyage to do business, and obliged himself to share the profit which the Lord would grant with the investor, who nonetheless bore liability for any loss incurred while on voyage, either in the normal course of trading or from an act of God or hostile men, in proportion to his capital investment. The merchant indeed might or might not add capital of his own to that of the investor. If he did, modern historians refer to the contract as a bilateral

commenda since both parties supplied capital; otherwise, it is referred to as a unilateral *commenda*. In the standard bilateral form the merchant provided one-third of the capital, bore one-third of the capital loss, and was entitled to one-half of the net profit in return for his labour and risky investment. In the standard unilateral *commenda*, the merchant did not supply any capital, assumed no liability for a capital loss, and received one-fourth of the net profit. Since the merchant took the capital away with him, on-the-spot management of the enterprise was entirely in his hands. Yet, the investor, who sometimes was a merchant himself, might give certain directions concerning the merchant's management and even undertake the sale of the return cargo (González de Lara 2011; Pryor 1983; Pryor 1977).

The *commenda* contract thus contained elements characteristic of both a (sea) loan and a partnership—without, however, strictly belonging to either category—and served multiple functions: it enabled the mobilization of capital from savings into risky investments in overseas trade, but also the provision of commercial services to handle an investor's business abroad.

In Amalfi and Venice, the *commenda* was considered a credit instrument, whereby a merchant-entrepreneur put other people's money into his use, offering fellow citizens from various means, ranks and occupations a lucrative investment opportunity (González de Lara 2008, Pryor 1977; Lane 1966; Luzzatto 1954). The merchant, who is identified as *debtor* by notarial practice and statutory law, took ownership of the capital he raised and conducted business under his own name, was allowed to amalgamate funds from many investors, who are identified as *creditors*, liquidated them with payment of the share of the profit agreed upon, retaining always possession of his own part, and was never bounded to trade on specific goods or to otherwise follow instructions coming to him by letter or by messenger from an investor (Luzzatto 1954, 68–72; Cessi 1917, 19–20, 28; Sacerdoti 1899, 14–15). The *commenda* in these localities was consequently a form of business investment and risk sharing, under which the merchant operated an overseas venture as a sole proprietorship and the investor participated in the profits or losses by contributing his capital, a form that recalls today's *cuentas en participación* or *associazione in partecipazione*, and, to some extent, *société en participation* or *stille Gesellschaft* (Alfaro Aguila-Real 2014; Mignone 2005).

Elsewhere in the Western Mediterranean, the documentary and statutory evidence identified the contracting parties as *partners* (Pryor 1977, 14–19; de Roover 1963, 50). The *commenda* was thus recognized as a (non-usurious) partnership, but it retained a legal position close to the

loan and the commercial agency. It was stipulated as an acknowledgement of debt by the merchant alone, even though he also invested capital in the bilateral form, and was terminated by an act of payment instead of an act of dissolution, which we would expect in the case of a partnership (Pryor 1977, 12; Luzzatto 1954, 104; Astuti 1933, 72–4; Cessi 1917, 60). Furthermore, with the exception of the *Constitutum Usus* of Pisa, which developed the concept of a separate patrimony in connection with the *societas maris*, municipal statutes did not recognize under a *commenda* contract the formation of a shared patrimony jointly owned by the partners, far less the creation of a separate fund legally distinct from other assets owned by the investor and the managing merchant (Udovitch 1962, 189; Weber 2003[1899], 132–4; Cessi 1917, 84). Unlike in Venice, however, the investor retained complete property rights and could also maintain his executive authority, requiring that his agent follow specific instructions (Pryor 1977; Pryor 1983). The travelling merchant, though, acquired rights and obligations with respect to third parties on his own behalf only; indeed third parties need not even be aware of the partnership's existence (Weber 2003[1889], 134; Pryor 1977, 21; Udovicth 1996, 198; Cessi 1917, 28). And so, contrary to the prevailing view among modern legal scholars, the *commenda* contract did not generally entail the creation of a new legal entity separated from the individuals that owned and managed the business venture (Harris 2009; Hansmann et al. 2006).

The *commenda* contract instead formalized relationships of agency and credit between the parties involved in the contract. Its dual nature as a labour and a financial contract is well reflected in the historical sources. In Genoa, for example, the preserved *commenda* contracts for the mid-twelfth century reveal an employment relationship: a few large-scale operators employed the labour of other merchants in their service to act simultaneously across geographically dispersed markets (van Doosselaere 2009, 106; Greif 1994, 928–30). The travelling merchants were, as a rule, men of little wealth and low position who played a subordinated role and who were not allowed to carry funds from more than one investor at a time (Pryor 1983, 142–6; Byrne 1916, 147–9). By the end of the century, however, trade opportunities opened up to a wider range of the city's people, men and women alike. Investments were made both by professional merchants and by individuals without business experience, by nobles and by commoners, by big investors and by small ones (van Doosselaere 2009, 78–118; Angelos 1994, 302). The travelling merchant then was no longer a poor agent dependent on the investing partner but the actual entrepreneur, typically a man of substance who raised additional funds by selling ownership interest in his own business through

multiple *commenda* contracts (Weber 2003[1889], 130; Cipolla 1993[1976], 196; Pryor 1983, 162; Byrne 1916, 157–8). The *commenda* thus became an instrument of trade credit and of investment in the form of equity.

The evolution of the *commenda* from a service contract to an equity investment was a widespread phenomenon occurring throughout the Western Mediterranean (Weber 2003[1889], 130–31; Pryor 1984; Berlow 1979). In contrast, the Muslim equivalent to the *commenda*, the *qirād* or *mudāraba*, remained an agency contract (Goldberg 2012; Greif 1989). Furthermore, even though it was not prohibited by Islamic law, agents hardly ever combined the capital of many principals in a pool of investments, if at all (Ackerman-Lieberman 2011, 655–6; Çizakça 2006, 11–12; Udovitch 1970, 255–7). These contractual differences had important efficiency and distributional implications. First, unlike in Europe, where 'savings [from the population at large] were activated for productive purposes to a degree inconceivable in previous centuries' (Cipolla 1993, 164), trade expansion in the Muslim World was constrained by the capital endowment of the merchants as a class. Individuals outside the circle of merchants could not invest in and profit from trade (Çizakça 2006, 11–12). Second, '*mudāraba* partnerships remained small institutions with limited capital' (Çizakça 2006, 21). This reduced the cost-efficiency of each single venture and, arguably, inhibited subsequent institutional, organizational and contractual developments that facilitated impersonal exchange in the West and thus market expansion (Greif 2012; Kuran 2011).

The new *commenda* contract combined the advantages of a sea loan with those of a partnership. Like in a sea loan, the investor bore no liability for loss beyond the sum or merchandise he had initially contributed and committed his capital only for the duration of a voyage or at most a limited period of time (Cessi 1917, 28, 41). The *commenda* contract thus provided the limited liability and liquidity needed for attracting investments from the broader public. At the same time, it protected the going-concern value of the funded venture against liquidation by the investor or his creditors. Unlike an ordinary partnership, which was consensual, the sea loan and the *commenda* were real contracts under which, once the merchant had taken possession of the capital from the investor, the former was bound to undertake the voyage agreed upon and the latter was compelled not to withdraw funds before the expiration of the agreed upon term (Pryor 1983, 137; Pryor 1977, 20). Furthermore, the investor's capital remained locked in even when the investor died or went bankrupt (Astuti 1933, 70-71; Hansmann et al. 2006, 1373; Weber 2003 [1889], 76–7, 134).

Like in an ordinary partnership, both parties shared profits and risks. Yet, the *commenda* contract entailed a novel rule for the division of loss: the managing merchant alone was legally responsible towards third parties but he bore no liability whatsoever for the investor's capital in case of partial or total loss due to circumstances beyond his control (Pryor 1977, 20–21; Udovitch 1962, 198). He was thus exempted from repayment not only in case of loss at sea or at the hands of hostile people, a contingency contemplated by the sea loan, but also in case of an unsuccessful commercial operation. By sharing the commercial profit and risk between the contracting parties and limiting the merchant's liability for loss of capital, the *commenda* contract provided a more efficient allocation of risk and reduced the cost of contract enforcement, thereby facilitating trade investments that would have not occurred in the absence of this contractual form and inducing a reallocation of both human and financial capital towards its highest value use (González de Lara 2017).

The Western *commenda* contract was, as John H. Pryor has remarked of it, 'the linch-pin of the fantastic success of the Commercial Revolution in the Mediterranean from the eleventh to the thirteenth centuries' (Pryor, 1983, 133). Yet, 'every thing about the structure of the notarial acts and the statutory law concerning it suggests that conflict of interest between the parties and the possibility of fraud were constant preoccupations' (Pryor 1983, 192). Besides the problem of outright embezzlement of funds, which was common to all forms of agency and investment in overseas trade and was mitigated through distinct combinations of coercion and reputation in different localities (González de Lara 2008; Greif 1994), the prospect of a false commercial account ranked first in contemporary minds. To ensure that the merchant did not divert part of the profit, he was typically required both to return to the home port to render accounts in person and to place the entire capital and proceeds of the *commenda* in the hands of the investor, who then divided the profits with his assistance (Pryor 1983, 169–78; Pryor 1977, 35–6; Byrne 1917, 136–7, 152; Krueger 1993, 261). The 1279 revision of the Statutes of Marseilles went as far as decreeing that all goods shipped back by a merchant should be taken directly from the lighter in which they were unloaded to the investor's home or into his possession (Pryor 1983, 175, 179; Hansmann et al. 2006, 1373). In Venice, however, tight administrative trading controls provided the (verifiable) information required for assessing a merchant's accounts and settling disputes without imposing such restrictions. Venetian merchants were thus allowed to dispatch the capital and proceeds that accrued to the investors in the care of a third party, without making the return voyage in person, and to retain

possession of their own share of profit, and also capital if the contract was bilateral (González de Lara 2008, 276; Pryor 1983, 178).

Conflict of interest could also arise from a merchant's actions and effort while doing business in distant markets. To protect the investor against careless speculation or outright fraud by the travelling merchant, large numbers of notarial acts for *commenda* contracts prohibited certain specific conduct to the merchant, such as lending money of the contract to political leaders in the Kingdom of Jerusalem or spending it on prostitutes and gambling (Krueger 1993, 262–4; Pryor 1983, 151–6, 164–5). At Barcelona, Pera, Pisa and Marseille the statutes placed further restrictions upon the merchant's freedom of action. Unless he was given permission to do so by the investing partner(s), the merchant could neither incorporate the capital entrusted to him in a pool of investments, from which it could not easily be extracted, nor abandon it in the care of a third party while he went on to further voyages (Weber 2003[1889], 130; Pryor 1983, 140–44, 163–4; Pryor 1977, 34–5). Furthermore, since the *commenda* was a fiduciary contract, the merchant was bound to act in good faith and in the best interest of the investor. Otherwise, he would be liable for any capital loss, including loss of anticipated profit (Pryor 1983, 160–67; Udovitch 1970, 203–18). Thus we know, for example, of a Genoese merchant who promised to make up any loss incurred by his 'fault' beyond the normal course of business in 1203 and of another merchant from Trogir who admitted his liability for the loss of 23 Venetian pounds and ten shillings stolen as a result of his 'negligence' in 1270 (Pryor 1983, 162).

The courts' enhanced ability to verify and punish a contractual breach, including a violation of the merchant's fiduciary duties, is manifested in the evolution of the contract's terminology, stipulations and forms. By the early thirteenth century, for example, many *commenda* contracts in Venice stopped invoking the merchant 'to render a complete, fair, and true accounting without any fraud or evil intent', as well as 'to make a profit' with the capital entrusted to him or otherwise 'to do business as best as he could', thereby suggesting that moral hazard became less of a concern (González de Lara 2017, 11, 15; Pryor 1983, 162). Furthermore, the vast majority of these contracts introduced stipulations that, in the absence of symmetric information, would have exacerbated conflicts of interest. Specifically, Venetian merchants were then given a high degree of freedom 'to do business, by land or by sea, carrying, entrusting, abandoning, and recovering all or part of the merchandise of the *commenda* wherever it seems good to them' and were allowed to 'dispatch' the investors' proceeds without returning in person to render accounts (González de Lara 2017, 12; Pryor 1983, 151–5). Elsewhere in

the Western Mediterranean the shift towards greater contract flexibility was not that profound (Pryor 1983). Yet, by the late twelfth century almost all contracts for the formation of *commenda* partnerships inserted a legal clause providing that the investor's capital should bear expenses and profits pro rata with all other capital carried by the travelling merchant. With no other safeguard to the individual investors, the merchant could then raise as much capital as possible through multiple *commenda* contracts (Pryor 1983, 144–6; Byrne 1916, 157–8). Last but not least, the progression of the *commenda* contract from its bilateral form, in which the merchant took one-third of the downside risk and held half of the residual claim, to its unilateral form, in which he did not share the downside risk and captured only one-fourth of the gains from his effort, also reveals a decreasing need to provide incentives through contract for the merchant not to take excessive risks and shrink while doing business abroad. The investors' recourse against merchants for loss incurred through their fraud or sheer neglect appears to have sufficiently constrained opportunism (González de Lara 2011).

The development of effective courts, which upheld and enforced clear-cut contractual and legal provisions in the West, thus facilitated the pooling of capital from disparate savers for investment in overseas trade despite conflicts of interest between the contracting parties. It was this institutional distinction that made the Western *commenda* an engine of revolutionary growth and upward mobility unparalleled in the Muslim world. The development of property law in medieval Italy further facilitated trade credit in the form of *commenda* contracts. A rule of weak entity shielding, which applied both to partnerships and to sole proprietorships, protected the goods carried in *commenda* from the personal creditors of their owners. Furthermore, personal creditors did not only lack priority of claim on a merchant's personal assets, but their claims were also generally disadvantaged with respect to those of business creditors (Hansmann et al. 2006, 1366–8; Weber 2003[1989], 76–7, 131–4; Hoover 1926, 509–10). These legal rules, together with the rule of limited liability and liquidation protection concerning investors, also facilitated the transferability of shares or credit rights, thereby enabling investors to use them as collateral and to assign them to third parties in case of urgent liquidity needs (González de Lara 2000, 223, 265–6; Hansmann et al. 2006, 1350).

4. PARTNERSHIPS, FAMILY FIRMS AND JOINT VENTURES

The medieval Italian partnership, the *compagnia*—from *cum panis*, i.e. sharer of the same bread—progressed from the Greco-Roman *societas* to the modern partnership form. Like the *societas*, it was a consensual agreement by which two or more partners, who might or might not be family, pooled their capital and labour for a common purpose or exploitation and shared the enterprise's profits and risks. The *compagnia*, however, had a separate fund distinct from the individual partner's own liable assets and operated under a joint name, as a firm, by which it conducted business. Each partner acted on behalf of the partnership when contracting with third parties and such actions resulted in solidary liability (joint and several rather than pro-rata) toward creditors for debts and obligations (Hansmann et al. 2006; Weber 2003[1889]; Sapori 1955). Although occasionally found in maritime trade, it was mainly used for land-based commercial and industrial enterprises (Berlow 1979, 358; Lopez 1976, 74–5; Luzzatto 1954, 105–7).

During the thirteenth century a distinctive type of *compagnia*, the family firm, emerged in various inland cities of north central Italy, such as Lucca, Siena, Piacenza, and, above all Florence (Weber 2003[1889]; Hunt and Murray 1999; de Roover 1963). By mid-century, a handful of exceptionally large family firms, the Bardi, Peruzzi and Acciaiuoli companies were engaged in both trading and finance over a wide geographical area (Sapori 1955). Just to give an idea of these firms' size, consider that in 1335 the assets of the Bardi Company were valued at about 4.5 times the English king's net income as late as 1433 and the firm's staff, in the range between 120 and 150 employees, matched even the mighty bureaucracy of the age, the Avignon papacy with its 250 administrators (Hunt and Murray 1999, 109; Greif 1996, 477).

It has been conjectured that these super-companies were created as extraordinarily large so that they could advance the huge loans required to obtain trading privileges from the English and Southern Italian rulers, who were in desperate need for large sums to finance their military campaigns (Hunt 1994). Thus, the super-companies got involved in trading and finance, both of which proved profitable. But subsequently, shortly before the Black Death, these super-companies perished when the specific circumstances that had led to their emergence disappeared. In particular, improvements in English administration reduced the king's need for continuous financing by private companies, and the increased regulations and taxation of the grain trade considerably diminished the

scope for profitable trading with Southern Italy (Hunt and Murray 1999). Despite the merits of this argument, it accounts neither for the family firm's non-appearance among the Muslim Karimi merchants, who nevertheless obtained the commercial protection of the Egyptian Sultan in return for massive loans during the late twelve century, nor for the family firm's persistence in the west, albeit if in a smaller version such as the late-fourteenth-century Alberti and Datini Companies, the fifteenth-century Medici Bank, or the myriad of small family firms that even today constitute the basic business unit of the industrialized countries (Greif 1996, 479).

The family firm has also been viewed as an essentially quasi-permanent ordinary partnership that emerged, independently of its size, in response to the agency problems associated with the separation between ownership and control (Greif 1996). Operating through branches was potentially efficient, but it did require the branch managers to maintain control over the partners' commercial business abroad, enabling them to act opportunistically. The family firm, however, did not mitigate this problem by using partners' relatives to work abroad, nor was it fundamentally a family concern. For example, none of the branches of the Medici Bank was headed by a Medici and only 18 of the Peruzzi Company's 88 employees in 1336 were related to any partner (de Roover 1999[1963]; Hunt 1994).

The family firm, unlike the ordinary partnership, provided credible signals that it will operate for a long-term period. By systematically renewing their articles of association, the Peruzzi Company lasted from 1275 to 1343 and the Medici Bank from 1397 to 1494 (Hunt 1994; de Roover 1999[1963]). This might have enabled the operation of a (bilateral) reputation mechanism through which the carrot of high salaries and long-term employment, on the one hand, and the stick of firing and legal suits, on the other hand, motivated agents, family members or not, to refrain from acting opportunistically. Indeed, the family firms paid high salaries, employed the same branch managers and officials for long periods of time, sometimes for life, and hired exclusively fellows from their home city to facilitate, if necessary, the agents' punishment by means of the legal system. Moreover, the evolution of the family firms' internal organization seems to have reflected a process of learning whereby better incentive and control schemes were adopted following the collapse of the three big super-companies, indicating that agency costs were perceived as having contributed to the super-companies' decline (Greif 1996). In particular, whereas the Bardi, Peruzzi and Acciaiuoli Companies remunerated their branch managers with high but fixed salaries, the later Medici Bank invariably used junior and subordinated

partners, who as such received a share of profits and were held unlimitedly liable for all the branch debts. In addition, the Medici Bank applied more accurate and regular financial controls and benefited from improved bookkeeping techniques (de Roover 1999[1963]).

Despite several changes in their internal organization (Padgett and McLean 2006; Melis 1962), the Italian family firms retained their basic structure as unlimited- and joint-responsibility partnerships throughout the centuries, most likely because this enhanced their ability to solicit deposits from the general public. Indeed, the Italian family firms accepted time deposits in amounts about ten times the firms' own capital (Greif 1996, 489–90). The need for personal liability as a basis for firms' credit is reflected in the failed attempt of Siena to relax in 1310 the joint and several liability rule that had previously prevailed and continued to prevail elsewhere. As a consequence, Siena rapidly declined as an important centre of business and indeed repealed the statutory clause providing that partners in *compagnie* bore only pro rata personal liability for firms' debts in 1343 (English 1988, 96; Sapori 1955, 804–5). As Hansmann et al. (2006, 1373–4) have pointed out, if pro-rata liability were an insufficient basis for credit, full limited liability would have been even less workable for the trading and banking firms of the time. Indeed, it was not until 1408 that a Florentine statute legalized the *società in accommandita* or limited partnership, in which non-managing partners were liable only to the extent of their investments (de Roover 1963, 75).

During the thirteenth century Venice also developed family firms, albeit in a distinctive form. The statutes of Jacopo Tiepolo of 1242 (Liber tertius, cap. IIII) regulated the *fraterna compagnia* as a new form of business organization. It established that brothers, with or without a living father, constituted a partnership as a matter of law, without the need of a formal contract of any kind. Each of the brothers was a permanent fully authorized legal agent for the others and was fully liable for his bothers' debts. The only protection against solidary liability was a formal, notarized, act of division. These acts were so important that notaries were required to file copies with the chancery (Weber 2003[1889], 104–7; Mueller 1997, 96–110).

The *fraterna* had existed as a community of heirs long before the mid-thirteenth century, but played a very limited role as a business entity until the late fourteenth century. The term *fraterna* indeed does not appear in the documentary evidence until 1171 and the various compilations of the statutes prior to 1242 neither use the term nor make any reference to the *fraterna* in the context of trade investments or business partnerships (González de Lara 2008, 258–9). Unlike the statutes of 1242, which explicitly excluded women from the *fraterna* partnership,

the early statutes contemplated the possibility that sisters remained undivided with their brothers, even after they married. In 1231, for example, Michele Simeone and his sister, Diana, wife of Biaggio Capo di Agnello, dissolved their *fraterna compagnia* (González de Lara 2000, 133). Diana acknowledged payment of all that accrued to her from their common inheritance, as well as from all business they had in common. In dividing the *fraterna*, Diana's dowry was discounted from her share, thus showing that all members of the family at that time had a claim to the assets of the household. The joint property of the household members, though, was evolving toward individual ownership and liability (Weber 2003[1889], 95–102). To maintain the males' creditworthiness and ability to commit to long-term employment with non-Venetians, it was therefore imperative to keep their patrimonies jointly intact for business purposes, and this is what the statutes of 1242 did. Yet, most Venetian merchants during the twelfth and thirteenth centuries operated independently: they were emancipated from their fathers early in their trading career and divided their *fraterna* soon after their fathers died and their sisters were dowered. Dissolutions were so natural that they did not require a notarized act until the mid-twelfth century. During the fourteenth century, however, the *fraterna* partnership progressively became the dominant unit of business in Venetian banking and overseas trade (Mueller 1997, 82; Luzzatto 1954, 117–23; Lane 1944).

Unlike other medieval family firms, the *fraterna compagnia* was not a purely business partnership constituted on a contractual basis to form a huge firm embracing many partners from various families for long periods. The Venetian family partnership existed *ipso facto* and was confined by law to two patrilineal generations of male relatives (Weber 2003[1889], 104–5). When a *fraterna* partnership required more capital or personnel, it formed a joint venture with other family partnerships or with persons of wealth and employed agents on salaries or on commissions.

Among these temporary associations for joint ownership and agency, the galley company and the *maona* are of special interest. They developed in the fourteenth century when the Venetian government began auctioning state-owned galleys for particular voyages. Galley companies were then formed to bid for the lease of a particular galley, pay the expenses to outfit it, and receive the corresponding freights. Ownership of the company was divided into 24 shares and management was delegated to a common agent, the galley master. Sometimes all the shareowners and masters of all the galleys in a fleet were unified through a *maona* contract to make a joint purchase. The purpose of forming a joint pool or *maona* was multiple: on the one hand, it assured that the

fleet as a whole would carry enough cargo or the right kind of cargo; and on the other hand, it reduced competition between the contracting parties, thus creating a monopoly rent. Neither galley companies nor *maone* were, in a strict legal sense, partnerships, far less independent legal entities from their owners, and they lasted only for the duration of a voyage or until a cargo had been sold (Stöckly 1995; Lane 1963; Lane 1944).

Without developing business corporations, Venice played a dominant role in overseas trade and colonization during the medieval period. The origin of the modern corporate form, featuring legal personhood, permanent capital, transferable shares, delegated management, and limited liability, is commonly associated with the chartering of the Dutch and the English East India Companies in the seventeenth century (e.g. Gelderblom et al. 2013; Harris 2010; but see Le Bris et al 2015; Malmendier 2009; Cessi 1919). During the Age of Exploration new opportunities for trade and conquest were opened to European nations with ocean access, but to profit from them it was necessary to make massive, long-term investments. Raising the necessary circulating capital on the market to make a voyage to Asia profitable did not require new organizational forms, notwithstanding its extraordinary cost, duration and risk. Yet, the funding of fixed assets in the form of a permanent Asian fleet and a central administrative hub, without which the companies' commercial and military aims could not have been realized, required the long-term lock-in of capital in an unprecedented way. The corporation, it has been argued, was the market solution adopted by the Dutch and the English to the new challenges posed by Europe's overseas trade with Asia (Dari-Mattiacci et al. 2017; Hansmann et al. 2006).

These challenges, though, did not differ much from those faced by the Venetians and the Genoese during the eleventh century, when the decline of the Muslim and Byzantine military and naval forces that had dominated the Mediterranean opened new opportunities for commercial and colonial expansion. Venice responded by building a state that effectively provided protective convoys and overseas possessions to her merchants (González de Lara 2008; Lane 1979). 'Since the state did so much, [there was] no need for any private business institution having either the longevity of the corporation or the large capital and the large powers of command which [were] organized in the [Dutch and English East India Companies]' (Lane 1944, 52). Genoa also went through a successful process of state-building, but Genoa's distinctive forms of government eventually collapsed in the mid-fourteenth century (Greif 2006, 217–55). The Genoese then developed the first joint-stock companies (Hansmann et al. 2006, 1376–8; de Roover 1963, 58–9). The *Mahona* of Chios, for

example, was a trading company with strong entity shielding, free transferability of shares and concentrated management that privately took over the island of Chios and the alum mines of Phocea in 1346, obtained monopoly privileges from the Genoese government in 1347, and exploited the conquered territories almost uninterruptedly for over 200 years. The *Mahona* was organized as a privately funded fleet because the Commune of Genoa was paralyzed by revolution and remained a private enterprise because the republican treasury was initially too exhausted to reimburse the participants in the venture, as had been agreed, and, after the initial concession of 20 years, Genoa never had the money to exercise the call option over the company's shares (Lopez 1938; Cessi 1919; Miller 1915). The history of business organization in medieval Italy thus casts doubts about the supposed superiority of the corporation in establishing European dominance and invites rethinking the extent to which different institutions, from the state to the family, passing through merchant guilds, regulated companies and joint-stock corporations, can prevail in different contexts, serving basically the same function though with different long-term implications.

5. CONCLUSIONS

The examination of business organization in late medieval Italy demonstrates that the organizational problems that business people faced in the past are those central to modern organizational theory, making history relevant to contemporary organizational analysis. They had to devise mechanisms for addressing moral hazard and incomplete contracting (Holmström 2016; Hart 2016), provide the lock-in of capital necessary to elicit long-term investments (Lamoreaux and Rosenthal 2005), and shield the assets of an enterprise from the personal creditors of its owners and managers (Hansmann et al. 2006), and from expropriation by the state (Dari-Mattiaci et al. 2017; Le Bris et al. 2015).

Merchants in late medieval Italy responded to these problems by designing better contracts and improving their regulatory, legal and judicial systems. Contractual and legal innovations were pervasive and exhibited a certain degree of uniformity across jurisdictions. Yet, each city-state developed a particular set of contractual stipulations and legal institutions, revealing significant local disparities in contract formation and governance. These findings call attention to the need to explore the extent to which contract and law conjointly mitigated organizational problems in other historical episodes, support the institutional distinction conjecture that set the origin of the Great Divergence in the Middle Ages,

and contradict the myth of a universal law merchant, produced, interpreted and enforced by a legally autonomous merchant class.

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4. Trading with strangers: the corporate form in the move from municipal governance to overseas trade

Ron Harris[1]

The transition from personally based business collaboration (which was confined to relationships with family and friends) to impersonal collaboration (with outsiders to one's social group) was a breakthrough in the economic rise of Europe. This chapter analyses the transformation of the usage of the corporate form from municipal based public purposes to business and trade purposes around 1600. The corporate entity was used in that transformative period as the platform for fostering sustained, multilateral, for-profit collaboration between strangers.

The chapter focuses on the formation of the English East India Company [EIC] in 1600 and Dutch East India Company [VOC – Verenigde Oostindische Compagnie] two years' later. Though it is a study of two business enterprises, it has far-reaching implications, first because the two played an important role in a major economic transformation – Europe's take-over of Eurasian trade, and second, because they were the first publicly-held business corporations and a model for all later adopters of this organizational form. The chapter argues that the formation of the EIC and VOC should be understood as a means to achieving collaboration between entrepreneurs who aimed at establishing oceanic trade with Asia, and passive outside investors who would only cooperate within an institutional framework that would reasonably protect their interests vis-à-vis the insiders. The institutional framework had to surmount several unprecedented hurdles. First, the high maritime and political risks involved in such oceanic trade with foreign territories. Second, the need for a large number of investors given the high shipping and trade costs. Third, the considerable informational asymmetry between the merchants in Asia and the investors in Europe. Fourth, the need for longevity of the

[1] This chapter distils the main arguments of Chs 9–11 of my forthcoming book: *The Birth of the Business Corporation East and West: Eurasian Trade Institutions and their Migration, 1400–1700.* I would like to thank participants in the University of Virginia Legal History Workshops for invaluable comments.

enterprise given the distance and the need to accumulate knowledge of the markets and the routes.

The chapter argues that a preexisting legal institution, the corporation, was put to new use in order to surmount these obstacles. In its traditional use the corporation already acquired a separate legal personality, with hierarchical and participatory structure of governance and with the understanding that corporate officers acted as agent on behalf of the corporation without bearing personal liability. Around 1600 the corporation was combined with a newly developed financial scheme, the joint-stock capital, which enabled numerous individuals to pool together pro-rata equity investment in an enterprise. The interests (shares) held in the joint-stock capital had an interface with the emerging government bond market. The amalgam of the legal concept of the corporation and the financial concept of joint-stock capital matched for the first time in history passive external equity investors with long-distance trade enterprises.

THE EUROPEAN ORIGINS OF THE CORPORATION

A long-standing debate surrounds the early history of the corporation. I identify four different approaches in the historiography of the origins of the corporation. The first, which views the corporation as a Roman jurists' invention, was advanced by law scholars and historians of Roman law, such as Duff (Duff 1938). They interpreted Roman legal texts and the *corpus juris civilis* as containing evidence for the existence of a corporate conception in classical Roman law. Recently, Malmendier suggested that the *societas publicanorum*, a society of government leaseholders, was the earliest predecessor of the modern corporation. Yet this institution, which appeared in the 5th century BC and reached its height during the republic, was not reflected in later legal texts such as *corpus juris civilis* (Malmendier 2009). More recently, Abatino, Dari-Mattiacci, and Perotti identified another Roman institution, the *peculium*, as a substitute for the corporation. The *peculium* provided *de facto* depersonalization by making a non-legal person the fulcrum of the business: the slave. This format exhibited all the distinctive features of modern corporations, including asset partitioning, thereby providing a functional equivalent of the modern corporate form (Abatino, Dari-Mattiacci and Perotti 2011). Even if the identification of corporate features in the *societas publicanorum* or the *peculium* is widely accepted

by scholars, these institutions, which might be very relevant for understanding Roman economy and may offer an interesting alternative to the corporation, had no direct continuation into the high Middle Ages.

The second approach in the historiography of the corporation argues that it is a product of 11th to 13th century revivers of Roman law scholarship in the newly founded Italian universities. According to that view, the Italian glossators and commentators, the interpreters of Justinian Code, read into a few scattered statements by Roman jurists a coherent legal concept unrecognized by contemporaries, doing so not as a scholastic exercise but rather in order to serve the new needs of their age (Avi-Yonah 2005). Specifically, they responded to their changing environment in which city-based associations such as independent city municipalities, universities, colleges, and guilds were gaining importance. These associations needed an institutional platform for owning property, setting governance structures, resolving disputes, and the like that the corporation provided.

The third approach views the corporation as originating in medieval Germanic tribal traditions. It points to the communal spirit of German tribes as evidence of a corporate ideology. This view was advanced by German nationalists, notably Von-Gierke, in the late 19th century (Von-Gierke 1900). Unlike Roman law and the south European Latin culture, which were individualistic in their orientation according to Gierke, the basic Germanic orientation was toward the group, the association, and the fellowship. This view lost support with the discrediting of German nationalism.

The fourth approach, which I am the most convinced by, considers the corporation an invention of the church and canonic law (Berman 1983, Grant 2001). Several controversies that shook the Catholic church between the 11th and 15th centuries – including over investiture (the conflict between the Emperor and the Pope), conciliarism (the conflict between the College of Cardinals and the Pope), and the papal schism (split between Avignon and Rome claimants to be the true Pope) – were often argued in corporate terms (Tierney 1955). The issues at stake included: who appoints the Pope?; who appoints Bishops?; does the Pope have to consult or seek the approval of the Council?; where did the authority and ownership of property lay when the seat of a Pope, a Bishop, or an Abbot became vacant?; did the Pope or Council of Bishops have the ultimate authority?; and was the church a corporation? Deep issues of hierarchy, centralization, and representation were discussed in corporate terms. We do not have to enter here into the history of the Catholic Church or the exact positions in the debates. What is important for our purposes is that the corporate concept was developed within these

controversies and was intended to resolve organizational aspects of the Roman Catholic Church. The emerging law of corporations became the constitutional law of the late medieval Church. The corporation provided legitimacy and working tools for the full range of ecclesiastical organizations, from the papacy to the monastery, fraternity, and religious order. The corporation served the objective of separation of the constitution of the Church from that of territorial rulers.

Why did the Roman Catholic Church, out of all the organized religions, need such a legal–constitutional conceptual framework? Two factors played an imperative role. While many religions developed as part of the apparatus of rulers and states, the Catholic Church aspired to separate from the Emperor and other lay rulers (Feldman 1997). While several major religions were decentralized, this church was centralized and hierarchical. The combination of these two factors, detachment from political rulers and hierarchical structure, made it singular.

The fourth view can, without any difficulty, be reconciled with the second view, or even absorb it. The use of the corporate form to solve the organizational problems of towns, colleges, and guilds was a positive spillover from the church. Had the church not developed the corporate form, these other bodies would have undoubtedly taken a different organizational path as they did in other parts of Eurasia.

Once the church had developed this form, the question of how to reconcile the canon law conceptualization of the corporation with Roman law texts had to be addressed. The glossators and commentators reread Roman law doctrines and institutions, not only in line with the new reality of towns and guilds, but also, or even primarily, in line with newly developed mediaeval canon law theory. After all, to take just two examples, Irnerius (1050–1125 or thereafter), the founder of the Glossators School at the University of Bologna, was involved in an investiture controversy, and Pope Innocent IV (1195–1254) taught canon law at the same University of Bologna before his ascendance to the papal throne. At this point, even the first view can be integrated into the fourth. Modern readers of Roman law found in it corporate conceptions that were inserted not by the original authors, classical Roman jurists, but rather by the interpreters of the texts, medieval legal scholars.

THE EARLY EUROPEAN CORPORATIONS

By the 15th and early 16th century, the corporation was already well established as an important organizational and constitutional tool in Europe. It was uniquely European. It had been employed for several

centuries for ecclesiastical purposes. Political rulers did not use the corporate form for their purposes. They relied on hereditary or religious legitimation. They did not want to design participatory forms of governance. However the corporate form had already spilled off to municipalities. Cities in some regions of Europe assumed a level of independence and autonomy from Popes and Emperors and from the rural feudal system. They found the corporation as a good platform for organizing municipal governance, and city-based economic activities such as craft guilds, merchant guilds, livery companies, regulated companies, and educational activities such as universities and colleges. Guilds, the most significant late mediaeval economically active corporations, had considerable social, fraternal, ritual, and even religious elements. They served as fellowships or brotherhoods that controlled and ritualized whole aspects of their members' lives (Black 2003, Epstein 1998, Ogilvie 2011). They were total institutions not passive investment tools, and they disciplined their members accordingly, applying social and religious norms and sanctions. Membership was determined by status and not contract. In modern terms they were not aimed at profit maximizing but rather as a regulatory order, performing public or semipublic purposes.

The features of the city-based corporation became quite stable. It had a legal entity separate from that of its members. Its legal personality secured longevity. It did not terminate with the death of any human individual; it was potentially immortal and subject to dissolution only in a strictly defined manner. A corporation could own and convey land, albeit at times with restrictions. It did not have to litigate under its members' names, but could sue and be sued, for better or for worse, in its separate personality, in the same manner as individuals. It could make bylaws to govern its internal affairs. As a legal entity, a corporation could acquire additional franchises, liberties, and exemptions from the state, usually in the incorporating charter or act itself (Coke 1628, Sheppard 1659, Blackstone 1765, Kyd 1793, Harris 2000).

Prior to the 16th century, a number of groups of merchants in England, such as the Merchants of the Staple and the early Merchant Adventurers, traded with nearby continental ports, but these were associations of individuals usually with no formal legal basis or corporate status. They operated on the basis of a licence or a franchise (Ogilvie 2011). In the second half of the 16th century, the corporation was increasingly used for the profit-oriented organization of trade. These English trade corporations are termed regulated corporations (Scott 1912, Harris 2000). This new utilization of the corporation for profit-maximizing resulted in no immediate change in its legal conception or in the features that characterized it. The regulated corporation was in fact a descendant of the merchant guild.

Members of the regulated corporation traded in their own stock, assuming risks and liabilities individually. Regulated companies collected entrance fees, annual payments, and duties on imported and exported goods. Money collected in this way was used to provide facilities and services for individual members, such as factories, embassies and consulates, and convoys. Thus, while each member traded separately, bearing investment and risk on his own account, some of the infrastructure was common.

The short-distance trade to nearby Western European ports was gradually organized in regulated companies: the Spanish Company, whose trade also covered Portugal, was chartered in 1577; the Eastland Company, for trading with the Baltic Sea and Scandinavia, was chartered in 1579; and the French Company was chartered in 1609 (Irwin 1992, Cawston and Augustus 1896). The territorial monopoly of Merchant Adventurers, that were first chartered in 1407, and again in 1505 and 1546 was extended in 1564 to include in addition to Flanders also the Low Countries and parts of Germany (Braudel 1982).

Towards the end of the 16th century long-distance trade to the outlying frontiers of Europe and to other continents – only entered into by English traders during this period – was organized in a new and experimental organizational form, the joint-stock corporations. Unlike the regulated corporation, the joint-stock corporation traded in only one account. That meant that members shared not only overheads but all business outcomes of the corporation – that is, all profits and losses. The first of the joint-stock companies was the Russia Company (also known as the Muscovy Company), founded in 1553 and chartered in 1555 (Willan 1956). Its initial ambitions included the discovery of the maritime Northeast Passage to Asia and to reach Asian markets overland. But eventually its main business was whaling and the fur trade. The Levant Company (Turkey Company) was formed in 1581 for trade with Turkey and the Eastern Mediterranean (Wood 1964, Epstein 1908, Braudel 1982). The Levant Companies traded with Asian goods but its business model was outdated by the time it was formed. Its merchants relied on Venetians and Arabs to carry the Asian goods to the vicinity of Europe. The two companies did not face the new challenges posed by the discovery of the Cape Route in 1497 and the massive import of Indian spices and pepper by the Portuguese to the European markets.

The experiment of both corporations with the use of joint-stock capital finance was not very successful. The initial investment in the joint-stock capital of the Russia Company did not reach the threshold of the high expenses needed for establishing the new trade nor the losses of ships and cargoes. In later years, more calls were made upon shares, with no

dividends in sight. As a result, in 1586, the company was financially reorganized under the same legal form, but using short-term rather than longer-term capital, and organizing it in several separate accounts, each for a period of one to three years. We shall see that this technique was adopted by the EIC a decade and a half later. This change stemmed from the difficulty in collecting from the original shareholders (Willan 1956). By 1622–23 this process had been taken one step further and the separate accounts were replaced by individual accounts. With this step, the Russia Company was in fact reorganized as a regulated corporation (Willan 1956). The financial structure of the Levant Company was debated as the charter expired in 1588. The merchants opposing the joint-stock trade had the upper hand, and the new charter of 1592 incorporated the Levant as a closed regulated company with high admission fees (Wood 1964).

There were also numerous other short-lived English joint-stock adventures, involved in explorations, privateering and one-off trade expeditions, some of them with Asian ambitions (Scott 1912, Shammas 1975), some of them competing with the Dutch pre-companies to which we shall turn in the next section.[2] So by 1599 the joint-stock company model had not proved itself as a good way for raising funding, for managing trade and for establishing a long existing enterprise. The early joint-stock companies were experimental, relatively small, and often short-lived and did not engage in the real thing, the Cape Route trade with Asia.

The quantum leap of the business corporation that involved the raising of joint-stock capital on an unprecedented scale, relying on more sophisticated financial design, longer-term basis, took place only with the formation of the EIC and VOC, in 1600 and 1602 respectively. To the changing trade environment, the two East India Companies and the institutional quantum-leap we now turn.

THE DUTCH AND ENGLISH: LATECOMERS TO EURASIAN TRADE

For many centuries, contact between Asia and Europe was based on the overland caravan trade using the Silk Road and parallel routes. This state

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[2] These ventures included the Merchant Adventures for Guinea; the Senegal Adventures; the Gynney and Bynney Company; the Greenland Company; the Barbary (or Morocco) Company; the Canary Company; the Cathay Company; the North West Company and many others.

of affairs began to change in the opening years of the 16th century with the arrival, in Indonesia and India, of the Portuguese who sailed around the Cape of Good Hope. The Portuguese trade was organized within the *Estado da India,* a branch of the state that combined mercantile, naval and imperial functions.

The direct Portuguese trade with Asia, which amounted to buying spices, tropical commodities, and other Asian goods at source, put English and Dutch traders at a disadvantage. Together with the Venetians, these traders traditionally bought spices and other Asiatic goods at the Mediterranean entrepôts that served as the western terminals of the overland Silk Road and of the maritime Red Sea and Persian Gulf routes. Now that these routes were bypassed by the Portuguese, they had to buy the goods from the Portuguese in Europe at higher prices. The Portuguese dominance also extended to controlling the network that distributed Asian goods, particularly spices, in Europe. The English Levant and Russian companies found it hard to secure an ample supply of Asian goods at the western ends of these routes in the Ottoman Empire and on the Volga. The Dutch, who had so far focused their maritime attention on the Baltic and the Atlantic, also wanted their share of the growing Euro-Asiatic trade. In the closing decades of the 16th century, there were already signs of a weakening of the Iberians' (now in the form of the Spanish–Portuguese Habsburg kingdom) control of the sea routes to Asia. These were manifested in the defeat of the Spanish Armada at the hands of the English, the advance of the Dutch Revolt, and the organizational crisis of the Portuguese ruler-owned Asiatic trade enterprise – the *Estado da India* (Chaudhuri 1965, Aghassian and Kéram Kévonian 1999, Scott 1912, Scott 1910, Furber 1976).

By the last decade of the century, Dutch merchants, organized in city-based organizations – the pre-companies – began sending annual voyages to Asia. A small group of English merchants, members of the Levant Company and the Russia Company, realized that they could not compete with the Portuguese and the Dutch if they did not switch from relying on the old technology, the overland caravan, to the newly-introduced one, the ocean voyage. But switching costs were significant. What were the costs of setting up an enterprise that could establish Eurasian oceanic trade? The scope of the capital and its outlay would determine the necessity for cooperation with others – outsiders.

The challenges faced by Northwestern European merchants in their efforts to enter the Eurasian trade could not be resolved using vehicles such as a single self-financing investor, a two-party investment contract, collaboration within a small and closed group of family and kin, or any other personally-based association. In order to enter this demanding trade

they had to break through the frontiers of well-established Eurasian institutions. The challenges could only be met by designing a multilateral institution that would pool together capital from a larger group of investors, based on impersonal collaboration. Voyages to Asia were all-or-nothing undertakings. The risk could not be insured. As the investment was mainly in working capital, ships, crews, and goods in remote seas, no significant collateral could be offered to creditors. Lenders to such incomparably risky undertakings were expected to demand prohibitively high interest rates. But high interest, to the extent justified by the risk, was a violation of the usury laws (Malynes 1622). The extreme business environment made it more difficult to align the interests of entrepreneurial equity holders and passive debt investors. What the entrepreneurs needed was a multilateral institution that could provide a good platform for equity investment, longevity, and capital lock-in. The joint-stock business corporation was invented to meet this need.

The major factors that influenced the decision of promoters to design a novel impersonal collaboration-enhancing institution were: an unprecedentedly high need for capital; wealth constraints of the organizers; and the inability to rely solely on finance through social networks. Other factors that affected the shape of the collaboration-enhancing institution were the high risks involved in the oceanic trade and the obstacles to information flow from Asia to England. All of these will be discussed in the next two sections as the actual design of the EIC and VOC is examined. As we shall see in each of the sections, while the two companies resorted to the corporate form and to joint-stock finance they solved institutional challenges in a corporate design that was quite different. The differences in legal, political and financial environment between England and the Dutch Republic led to the different design of the two corporations.

EAST INDIA COMPANY

In September 1599, a group of London merchants held a number of meetings that turned out to be the founding meetings of the EIC. The group was dominated by members of the Levant Company who felt it was crucial for them to enter the oceanic trade with Asia, now that the Dutch pre-companies had joined the Portuguese in using the Cape Route

to the Indian Ocean markets.[3] The promoters decided to work on two parallel tracks – one for obtaining a royal charter that would incorporate them as a corporate entity and license them to enter trade with new territories, and the other for raising equity capital for voyages to the East Indies from a large number of passive investors in the form of joint stock (Harris 2005a).

The Charter Track

The promoters negotiated with the Privy Council for a charter of incorporation, customs privileges, and licence to export specie, monopoly, and possible political and military support. Queen Elizabeth I granted the charter to the EIC on 31 December 1600 (Stevens 1967, Harris 2005b). But she promised no investment or naval support. The first part of the charter created a corporate legal personality (Hale 1976, Maitland 1908). Its most distinct attribute, as evident in the charter text, was that it was incorporated as 'one body corporate and politik', a separate legal entity. It had a full set of legal capacities and privileges: to own land, litigate in court, and hold franchises – such as monopoly.

The EIC was incorporated in its first charter for a period of 15 years. For the same duration, the EIC was granted an exclusive trade monopoly for 'all the Islands, Ports, Havens, Cities, Creeks, Towns and Places of Asia, Africa, and America, or any of them, beyond the Cape of Bona Esperanza [Good Hope] to the Straights of Magellan'. The monopoly meant that other subjects of Elizabeth could not trade with that part of the globe without EIC's permission. In the second charter, granted in 1609, James I decreed that the EIC should 'for ever be, and shall be one body corporate and politick' and enjoy all the aforementioned privileges of incorporation indefinitely, making the corporate body and the monopoly perpetual, subject to recall with three years' notice (Shaw 1887).

From a formalistic legal perspective, the new EIC had a charter and a legal status similar to that of the various municipal and regulated trade corporations. The Charter of the EIC defined its basic governance structure (see Figure 4.1 below). This included a Governor, a Deputy Governor, a Committee of 24 – also called the 'Court of Committees'

[3] Thus, the explanations for the design of the EIC and the reasons for that design are somewhat speculative. They are based on an analysis of the available organizational options in 1600 England, on those of the post-formation concerns and discussions preserved on record, and on theoretical insights as to the advantages and shortcomings of each of these.

(and after 1709, the 'Court of Directors') – and a General Court composed of all members of the company (Shaw 1887). Voting in the General Court as in other corporations was based on one vote for each member.

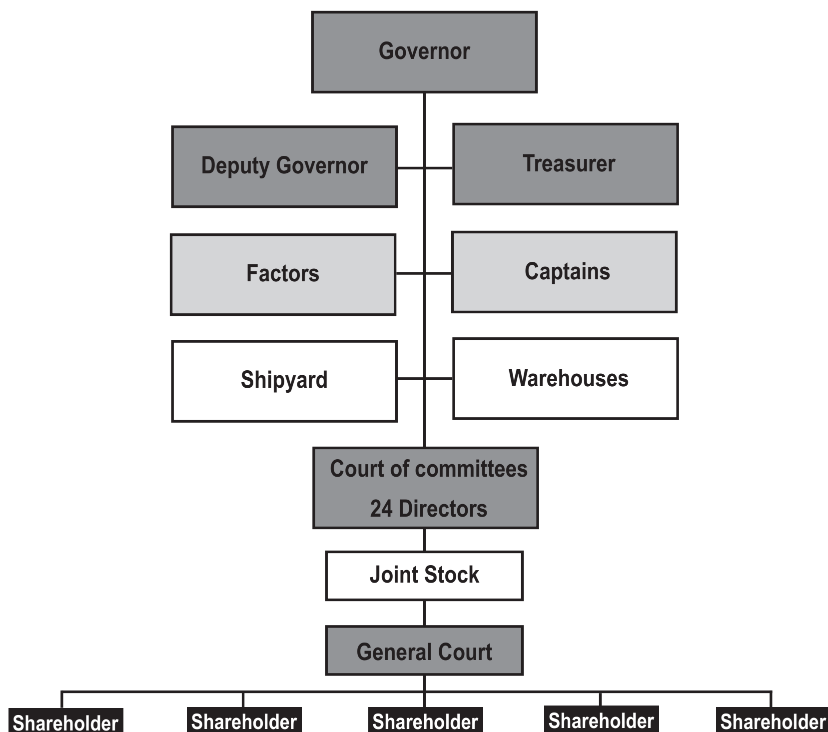

Figure 4.1 Governance structure of EIC

As a corporation the EIC was organized in continuation of centuries-long English and European corporate tradition. The 1600 Charter used the general template and governance structure of earlier regulated corporations. The level of investment in the EIC joint stock did not affect the voting rights of members. Each member had one vote as was the case in older municipally based corporations. The 1609 Charter took into account for the first time the level of investment and granted one vote for every £500 invested. This made £500 the minimum holding to qualify for voting. In practice, most of those who passed this threshold had one vote, or at most two. This was the very first sign for a deviation from the corporate governance tradition. It came about due to developments along

the joint-stock track. Towards the end of the 17th century the differentiation in voting rights based on value of shares in the joint-stock capital increased (Shaw 1887).[4]

The Joint-Stock track

The second track, raising joint-stock capital, was where the innovative institutional action was really going to take place. As we have seen, the exceptionally high capital investment threshold of oceanic trade, the wealth constraints of merchants and the high level of risk involved, made it necessary to raise small amounts of money from a large number of investors, including from outsiders to the overseas trade sector.

The first recorded meeting of the EIC promoters on 22 September 1599 was devoted to advancing this solution and inviting potential investors to commit. A list of subscribers was prepared, noting the names of the 132 individuals who signed for total capital of over £30,000. Individual sums varied between £100 and £3,000, with £200 being the most common sum. By the time the charter was granted (on 31 December 1600), there were 218 chartered members, presumably all subscribers (Shaw 1887). All investors in the joint stock up to that point were listed in the charter. This was the first and last formal overlap of the two tracks. Further subscriptions were accepted up to the departure of the first voyage (13 February 1601),[5] and by then the total number of subscribers had reached 232 and the total capital had risen to £68,937 (Scott 1910, Harris 2005a). This was the first joint-stock capital of the EIC. The joint-stock was a financial and an accounting concept. It enabled the pooling together of capital from numerous equity investors. The understanding was that at the end of the venture the investment, with added pro-rata gains, or minus pro-rata losses, would be distributed to the original investors.

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[4] This arrangement was retained in the 1661 Charter. The 1693 Charter established a system of one vote for every 1,000 shares up to a maximum of ten votes for holders of 10,000 shares or above. In the 1698 Charter, a somewhat different method was fixed: one vote for holders of £500 in shares and above, two votes for holders of £1,000 and above, three votes for holders of £2,000 and above, four votes for holders of £3,000 and above and a maximum of five votes for holders of any amount over £4,000. A minimum of £2,000 in shares was set as qualification for directorship. See (Shaw 1887), Charter of 1600, Charter of 1609, The Charter Granted by Charles II on 3 April 1661, Charter of 1693, Charter of 1698.

[5] In the contemporary Julian calendar, the year began on 25 March thus the voyage left 14 months after chartering.

It is important to note that, while the basic joint-stock financial structure of the EIC was set before its charter of incorporation was granted, the charter did not reflect this structure. It was practically identical in content to the charters of 16th century regulated corporations. On the financial side it was taken for granted by the members that profits on the initial investment would be divided, based on the share of each adventurer in the joint stock. On the governance side it was also taken for granted that each adventurer would have one vote in the General Court.

The real challenge for the promoters of the EIC, because of the exit option at the end of each voyage, was to draw additional investment to the joint-stock of each subsequent voyage. The court minutes of the EIC are full of calls to raise more capital and send more ships, goods, and silver, due to requests from agents in Asia, and to match the large number of ships sent annually from 1602 by the VOC. A new account was formed for each voyage to Asia, and members could decide whether, and how much, to invest in each voyage. Expenses at home and abroad relating to a specific voyage were recorded in the relevant account. At the end of the voyage, the proceeds from the sale of the imported goods, less expenses on exported silver and goods, shipping, wages, and bonuses, were divided pro rata among the investors in that voyage. As the investment was mainly in working capital, liquidation of the account was, theoretically, not overly problematic. Whatever fixed capital was left, mostly in the form of surviving ships, was sold to the next voyage and transferred to the next account. But, due to mixing of activities the joint-stocks of two voyages would occasionally be merged. Altogether £464,284 was invested in 12 joint-stocks, used for 12 voyages, within just 13 years. This was an unparalleled sum in English history.

Achieving such a high level of investment required the circle of outside investors that were not personally connected to any of the insiders to be recurrently widened. Insiders had to maintain their reputation when managing the EIC, its voyages, its business, and its distribution of profits, and nurture the relationship with passive outside investors so they would invest repeatedly in the ongoing voyages.

Not only the mere size and the expansion of the investing group, but also its diversity, support my claim that the EIC represented a breakthrough to impersonal collaboration. Levant merchants were at the core of the group that established the EIC – the insiders (Brenner 1993).[6]

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[6] There are no investment records for the second voyage. The database constructed for the present work, based on Rabb's memberships in the Levant Company, holds slightly different numbers: 19 of those present in the first

Table 4.1 Capital invested in each of the EIC voyages

Year	Voyage	Capital in £	Profit in %
1601	1st	68,373	Combined with 2nd voyage
1603	2nd	60,450	95
1606	3rd	53,500	Combined with 5th voyage
1607	4th	33,000	Total loss
1608	5th	13,700	234
1609	6th	80,163	122
1610	7th	15,634	218
1611	8th	55,947	211
1611	9th	19,614	160
1611	10th	46,092	148
1611	11th	10,669	230
1612	12th	7,142	134
Total		£464,284	

They were joined by Venice Company and Russia Company members. In addition, a few captains, navigators, privateers and explorers can also be viewed as insiders (Rabb 1967).[7] These insiders evaluated the EIC's financial needs and selected the institutional design that would attract a larger group of passive investors into the new and evolving enterprise.

Potential passive investors in the EIC could come from a wider circle and a variety of social and professional groups. They included members of the gentry and the aristocracy who were willing to undertake moderately speculative investments in the Asian trade. They included English merchants who were involved in the traditional wool- and cloth-based trade with Europe – the active members of the Eastland, Spanish, and, particularly, Merchant Adventurers-regulated corporations. Other potential external investors came from among London's well-established manufacturers, retailers, and artisans: tailors and mercers, skinners and

meeting, five of those appointed directors there, and eight of the committees identified as Levant members.

[7] In a study covering the period 1575–1630, Rabb identified almost 43% of Levant Company members (157 altogether) also as EIC members, and about 19% of EIC members (230 altogether) also as Levant Company members. The percentage of overlap from the Levant side decreases as it covers members for the period from 1581 to 1630, but the EIC was formed only 19 years into that period.

drapers, goldsmiths and ironmongers (Brenner 1993, Grassby 1995). Members of all three groups could not devote much personal attention to the Asian trade but would consider diversifying their limited fortunes within an appropriate institutional framework.

In 1613, a first longer-term joint stock was raised, for a period of eight years. A second joint-stock was raised in 1617 for 15 years, even though the first was due to dissolve only four years' later. A third joint-stock was raised in 1632 for ten years. Capital was separately raised in 1628, 1629, and 1630 for three Persian voyages, while the second joint-stock was still in effect. The various pending joint-stocks of the company were integrated into one permanent stock in 1657 (Chaudhuri 1965, Scott 1910, Scott 1911).

The total capital of the EIC grew steadily over time. As mentioned, the capital for the first voyage of 1601 was £68,000; the capital of the first joint-stock of 1613 was £418,000 and the general permanent stock of the company was £370,000 in 1657, £740,000 in 1682, and £1,488,000 in 1693. In 1709, after the merger of the 'old' and 'new' East India Companies that competed for a few years, the stock of the United East India Company was £3,163,000. It reached an all-time high of £6,000,000 in 1794. Throughout most of the 17th century, the EIC was the largest joint-stock company in England (in capital) and second in Europe only to the VOC. By the 18th century, the EIC was second in capital only to the Bank of England and had overtaken the VOC to become the largest trading corporation in the world (Scott 1912, Harris 2005b).

To sum up, pairing the financial tool of equity investment in joint-stock with the legal concept of the corporation amounted to a major institutional breakthrough. However, this innovation created a whole new set of challenges that had to be dealt with. The initial innovation gave impetus to various financial learning-by-doing experiments, on the capital raising end and the capital distributing end, that lasted several decades. The EIC was transformed from a financial scheme of ad-hoc per-voyage capital (one–three years, invested in specific ships), to capital for limited duration (eight–15 years), and finally to permanent and continuous capital. After the middle of the 17th century a more stable model emerged that resembles the modern business corporation, having permanent stock, distribution only of profits and voting rights that are proportional to the financial investment.

VERENIGDE OOSTINDISCHE COMPAGNIE

In the seven years that predated the formation of the VOC, the years 1595–1602, the Dutch Asian ambitions were channelled into newly-formed business entities called, in retrospect, *voorcompagnieën* or pre-companies, meaning the precursors of the VOC. They are important for understanding the mix between continuity and change reflected in the organization of the VOC and the organizational differences between it and the EIC. The first of these pre-companies was formed in Amsterdam by nine merchants in 1594 (Pauw and Karel 1936), and was named the *Compagnie van Verre* (Far Lands Company). The active entrepreneurs, known as the *bewindhebbers,* initiated the formation of the company, determined its business plan and received commission for extra efforts, while passive investors, the *participanten,* were invited only to a share of the profits based on the sums they had each contributed. They invested through the active partners who, supposedly, represented them. The first pre-company served as a model for several additional pre-companies. Altogether, 16 voyages, composed of 66 ships in total, were sent by companies from various cities in the southern and northern Netherlands within this seven-year period, using the pre-company model (Bruijn, Femme and Ivo 1979).[8] The pre-companies, unlike ship ownerships, were asymmetric in the sense that they had two classes of partners. The pre-companies were based, conceptually and most likely also historically, on the *commenda*. They were partnerships in the trade business and not in the ships themselves.

The intense competition between these pre-companies had the effect of raising prices for the Dutch purchasers in Asian markets and lowering the price of Asian goods to Dutch sellers in Dutch and other European markets. It was also wasteful in terms of the multiple investments in infrastructure made by the various pre-companies. In 1602 in a bid to achieve monopoly prices, at least in the Netherlands, to save on infra-structure costs, and to coordinate the struggle against the Portuguese and against the recently incorporated EIC, six city-based pre-companies (from Amsterdam, Delft, Rotterdam, Enkhuizen, Middelburg, and Hoorn) unified into a single cartel, the United East India Company (the VOC) (de Vries and van der Woude 1997, Prakash 1985, Steensgaard 1977). The VOC was formed on the basis of these earlier business entities, and was chartered on 20 March 1602 by the States-General, the federal assembly of the Dutch Republic.

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[8] Some of the sources count 14 voyages and 65 ships.

The preamble of the charter emphasized the company's private, or at least semi-private, character and its profit-maximizing goal. The charter fixed the existence of the company as a legal personality for 21 years. Unlike the charter of the EIC it also outlined its financial structure. It is noteworthy that two levels were addressed, the corporate longevity level and the capital lock-in level. Although this charter, unlike that of the EIC, does not allude to the creation of a corporation in so many words, in fact it creates an entity separated from the state and separated from individual persons that can own property, transact, and hold privileges from the state (de Jongh 2011, de Jongh 2014).[9] Furthermore, the charter contains a permission to issue a public offering of shares, grants all residents of the Netherlands the right to subscribe to such shares, and locks-in the capital so raised for a period of ten years – a long duration yet half the longevity of the corporate entity.

Each city-based VOC Chamber opened its share subscription counters and its own share registry following the issuing of the charter (see Figure 4.2 below). The active members of the VOC, those who were active partners in the pre-companies, led the marketing of shares and opened subscription offices. Information about the new company, the lucrative Asian trade, and government support was circulated in various ways. By the last week of August 1602, mania had erupted. Altogether, 6,424,588 guilders was raised across all six chambers (McCusker 1978, Denzel 2010).[10]

Figure 4.2 also shows the number of subscribers in the Amsterdam chamber and Middelburg chamber (for which subscription books have survived), and calculates the average value of an individual share (in guilders). The capital and the number of investors were far higher than in any previous Dutch enterprise or the recently-established EIC, or any other known Eurasian trade enterprise.

It is very likely that some of the money came through social networks. But the number of investors, the fact that many of them came from professions that were not connected to trade and the wide geographical area from which investors came, suggest that they were quite heterogeneous in their previous connection to the *bewindhebber* (den Heijer

[9] The question of whether the incorporation also entailed limitation of liability is debated among scholars. See, for example: (de Jongh 2011) and (de Jongh 2014).

[10] The joint-stock capital raised by the EIC in 1601–12, £464,284, is lower than that of the VOC. It is equivalent to about 4,750,554–5,049,088 guilder based on the lowest and highest exchange rates between pound and guilder in the period 1603–10: 10.232 pounds per guilder and 10.875 pounds per guilder.

Chamber	Capital (in guilders)	Number of subscribers	Average value of individual share (in guilders)
Amsterdam	3,679,915	1143	3,220
Middelburg	1,300,405	264	4,926
Enkhuizen	540,000	N/A	N/A
Delft	469,400	N/A	N/A
Hoorn	266,868	N/A	N/A
Rotterdam	173,000	N/A	N/A
Total:	6,424,588	1,815	3,540

Figure 4.2 VOC share offering 1602 – capital and subscribers

2005, Van Dillen 1958). It seems that many investors decided to place their money with an anonymous company – on the basis of business plans – and not with familiar faces. This was a major shift from personal to impersonal collaboration – from a local *bewindhebber* attracting a few familiar passive investors in a pre-company, to a united VOC with approximately 70 *bewindhebber*, about 1,800 shareholders, and a huge capital of nearly 6.5 million guilders coming from six cities.

The initial public offering of shares was not accompanied by additional offerings. The original capital was 6,424,588 guilders, and 90 years' later, in 1693, it was still 6,440,200 guilders (the slightly increased sum resulting from technical adjustments). Unlike in the EIC the VOC's activities and investments throughout the 17th century were financed through retained profits and loans, and not through the raising of additional equity.

The first profits account was set to be conducted after ten years. Investors were locked-in, allowed to withdraw their capital, principal, and profits from the company at that exit point but not before, and their full exit was dependent on raising capital from the new investors in a second joint-stock. The investors in the first joint-stock were not allowed to simply strip and divide the VOC assets at the end of any voyage, and not even in 1612. Shareholders were not entitled to accounts at the end of each voyage, which meant they were not entitled to information or dividend, the latter being at the discretion of the active shareholders (den Heijer 2005). In fact, dividends were distributed only once in the first ten

years, in 1610, and even then they were in-kind (pepper) and not in cash (Van Dillen 1935, Gelderblom and Joost 2011).

The VOC governance structure (see Figure 4.3 below) reflected the fact that it was a horizontal merger of preexisting pre-companies. It had six city-based chambers, one in each of the cities in which *bewindhebbers* who invested in the pre-companies resided. Each chamber had two classes of VOC shareholders: *bewindhebbers* and *participanten*. As in the pre-companies, the *bewindhebbers* had the status of directors/governors and took an active role in management of the chamber; the *participanten* were not allowed to take part in decision-making.[11] The *bewindhebbers* of each chamber met regularly to discuss managerial issues, while there was no general meeting of all the shareholders, either on the chamber or corporate level, and thus *participanten* had no access to information and no voting rights.

Each chamber had an Assembly of Directors (with seven–20 members, based on size as decreed by the VOC Charter) and various offices and services, such as an audit office, treasury, warehouses, and shipyard. The VOC had a central management function, the board of directors known as the Heren XVII (the Seventeen Directors), which was in charge of general policy (Gaastra 2007). These directors operated in assembly and through committees, and were assisted by an advocate. Only chamber governors were eligible to serve as VOC directors. The managerial structure of the VOC reflects both the fact that it was a merger of preexisting companies and that it was oligarchic, having two classes of shareholders.

The active shareholders offered passive investors no voting rights, no information on trade, no account of profits, and thus no share in control (den Heijer 2005). The VOC was also being used by the financial–political elite to promote the military, religious, and political aims of the republic and the provinces (Adams 2005). It was not managed as a purely profit-maximizing enterprise. Even when the VOC was doing well and making profits, its dividend policy was very restrictive, as described earlier. The active shareholders used their positions as both merchants and city magistrates to exercise political influence on provincial and

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[11] More accurately, *bewindhebbers* were required to hold a minimum amount of shares – 1,000 Flemish pounds (500 for Hoorn and Enkhuizen) – to qualify for their status. They could not sell their status as *bewindhebbers* in the market. That status was hereditary. They were allowed to buy a larger share in the profits but they could not, by this, gain more voting power.

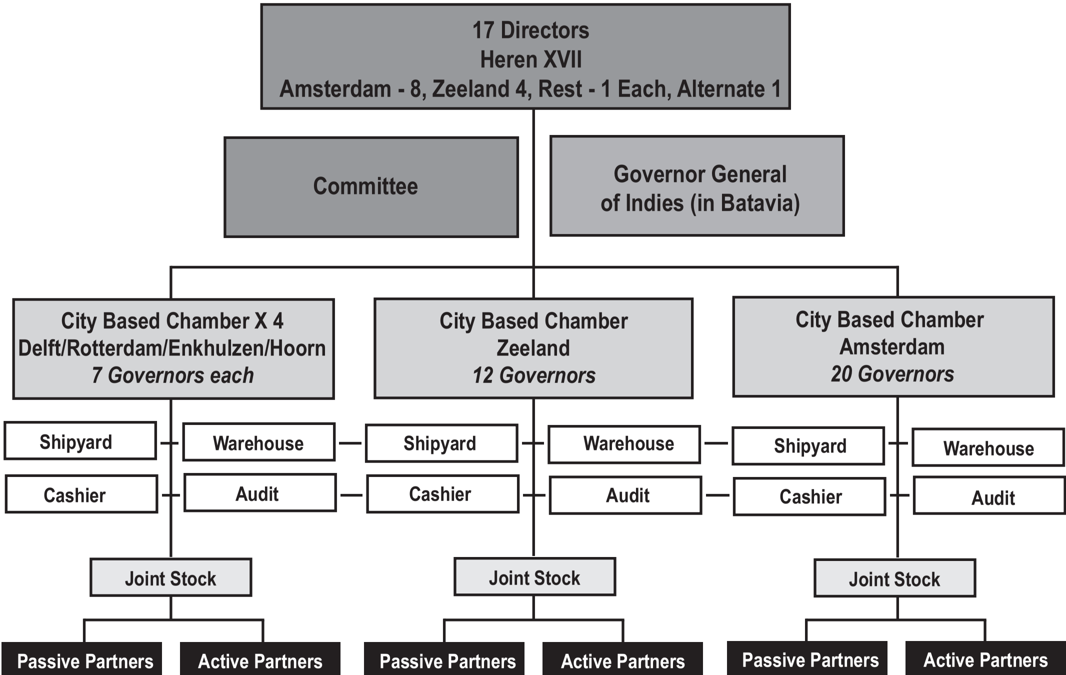

Figure 4.3 Organizational structure of VOC

federal governments and to unilaterally lock-in the external investors by way of the original charter and locked-in the passive investors again in 1612 at the end of the ten-year period.

Once locked-in again, the passive investors became agitated. The demand of the passive investors to participate in management was avoided throughout the first joint-stock and again in 1612 (Gepken-Jager 2005, den Heijer 2005). The passive investors did not achieve much in terms of the release of the lock-in and the focus on profit maximizing.

They were more successful with the exit option. There appears not to have been any significant trading in shares of pre-companies, probably for three main reasons: the pre-companies were limited in time to one venture; the number of members of each was small; and they were personally connected and unwilling to include outsiders. The VOC was a much larger and more impersonal enterprise. Its shares were not bearers' shares, and no share certificate was issued to holders (Van Dillen 1958). Thus, no physical asset could be conveyed by private contract.

However, its charter included a clause that allowed transfer of shares by registering the transfer in the VOC books in the presence of two directors and subject to the payment of a small fee. Shortly after the formation of the VOC, its shares were traded in the various city chambers. An important study by Gelderblom and Jonker convincingly documented the volume of Amsterdam Chamber VOC shares traded in the years 1603–12 (Gelderblom and Jonker 2004). Roughly 0.5 per cent to 1.5 per cent of the shares were traded every month. Nearly 33 per cent of the shares changed hands in the first decade. The Amsterdam stock market became sophisticated, with full-time brokers, a meeting place, and several non-spot transactional designs (Gelderblom and Jonker 2005). The Amsterdam *Beurs* building was built in 1611, shortly after the establishment of the Bank of Amsterdam (*Wisselbank*) in 1609. The Tulip Mania of 1636–37 manifested the sophistication and centrality of the Amsterdam markets (de Vries and van der Woude 1997, Garber 2000, Neal 1990).

The VOC's charter was renewed in 1622 and then again on several occasions during the 17th century and beyond. The monopoly was extended as part of the extended charter (Gaastra 2007). By 1610, some 76 ships had been sent by the VOC to Asia around the Cape, and 117 in the following decade (de Vries and van der Woude 1997). The VOC was able to beat the Portuguese, at sea and on shore, to conquer many of their factories and forts – including Malacca, Hormuz at the entrance to the Persian Gulf, Galle in Sri Lanka, Quilon and Cochin on the Malabar Coast, Southern India, and parts of the Spice Islands (Moluccas) – and to establish its presence from the Cape of Good Hope and the Persian Gulf

to Formosa and Japan. Batavia (modern-day Jakarta) in Java became the headquarters of the VOC in Asia. It was the hub of Dutch inter-Asian trade and the informational hub of their entire Indian Ocean and Cape Route business and eventually of the Dutch Asiatic Empire (Parthesius 2010).

The VOC rose to the position of the leading player in the Cape Route trade of spices and silver, sending more than 230 ships per decade eastward in each of the last four decades of the 17th century. Altogether, an unprecedented number of 1,770 ships were sent eastward by the VOC during the 17th century. It became a major player in the Indian Ocean trade of silk, porcelain, cloth, and precious metals, with a presence in Japan, China, Taiwan, the Spice Islands, Java, Sri Lanka, India, and other locations (Findlay and O'Rourke 2007).

Before turning to the utilization of the new joint-stock type of corporation elsewhere in Europe I would like to assess the difference in the details of the design between the VOC and the EIC and to explain these differences (Harris 2009). The VOC, supported by the state, could lock-in investors and legitimize a hierarchical and oligarchic governance structure. The EIC, lacking strong state support, could not lock-in investors. Thus it had to attract investors again and again to invest in the joint-stock of each voyage made by the EIC. It had to base itself on fully voluntary cooperation and to offer outside investors a more democratic and participatory governance structure. While passive shareholders of the VOC had no voting rights the shareholders of the EIC were offered voting rights. While the passive shareholders of the VOC had no access to trade information and to financial accounts, the members of the EIC received information and accounts in general annual meetings and ad hoc meetings.

The initial investment of the shareholders of the VOC was locked-in ex-post by the Dutch state for ten years that was later prolonged for the entire 21 years' duration of the first charter. Due to the involuntary nature of the lock-in and the protests that followed it the VOC had to provide the locked-in passive and voiceless investors with an exit option by developing a liquid secondary share market. The VOC offered liquidity that did not amount to withdrawing the initial investment (and in fact even the accumulated profits) but only a transaction in the shares that reflected in the pricing of the imposed lock-in. The exit option through the sale of shares in the secondary market was introduced because of the need to offset the lock-in of capital. The option was exercised with growing frequency by passive investors, partly offsetting the oligarchic and non-voluntary effects of the other institutional features of the VOC. The VOC profitability was most likely higher because it could invest in

longer-term activities and facilities. And it was reflected in the eventual dividend (Dari-Mattiacci, Gelderblom, Jonker and Perotti 2016).

The EIC offered a full withdrawal option of principal and profit at the end of each voyage. But this meant that there was no longevity of the joint stock and this affected the ability of the trade enterprise to expand, invest in infrastructure, increase volume of voyages and goods and ultimately its profitability. Because it was managed as an investors' club and did not have to provide liquidity through a stock market the EIC did not give rise to a secondary share market in England. The financial design of the early EIC was not followed by future business corporations but the governance structure of the EIC was the basis for development of modern corporate governance (Harris 2005b). The different design of the EIC and the VOC resulted from the different political environment and the different financial environment, which caused differences in the governance model and in the financial design between the two companies.

THE REST OF EUROPE

The English and Dutch models of organizing Eurasian trade, the EIC and the VOC, attracted attention throughout Europe. There were attempts to imitate the successful models, but as we shall see in this section, the copies were not nearly as successful as the original, and most failed. I identify two types of failed attempts. The first type, in Portugal, France and the Habsburg Empire, failed because it was initiated in an absolutist state that was unable to credibly commit not to expropriate the company's assets. The second type was in fact an attempt by English and Dutch interlopers to bypass the trade monopoly imposed by their countries through incorporation in foreign jurisdictions.

The shift in Portugal from a trade that was fully controlled by the King to the corporate form of organization was a reaction to a decline in trade and shipping in the face of successful competition in the early 17th century from the expanding VOC and EIC (De Silva 1974, Disney 1977). In 1628, the Portuguese Crown incorporated an East India Company (*Companhia do commércio da Índia*) for 12 years. King Philip III granted the company monopoly over the main Asian goods, including pepper, cinnamon, coral, and ebony. He committed to invest in the company and not to withdraw his share of the profits before the end of the 12-year term nor to intervene in the management of the company. These privileges and commitments were meant to make the Portuguese company attractive to private investors, yet it was unsuccessful in raising sufficient capital from outsiders. Most of the capital, about 80 per cent,

was eventually invested by the Crown, and much of the rest was invested by other public bodies such as towns and villages. The company was never fully separated from the state, its capital, its aims, or its personnel. Ultimately, it was unable to attract enough private investors and was dissolved five years into its 12-year term, in 1633.

In France unsuccessful companies for trade with Asia were formed in 1604, 1615, and 1626. A somewhat more successful company was set up in 1642 and renewed in 1652, but it seems not to have been active beyond the island of Madagascar. The most significant French company, *Compagnie des Indes Orientales*, was planned by Jean-Baptiste Colbert and chartered by King Louis XIV in 1664 for 50 years, with a monopoly for trading between the Cape of Good Hope and the Straits of Magellan. It resulted from the fusion of three earlier companies, the *Compagnie de Chine*, the *Compagnie d'Orient,* and the *Compagnie de Madagascar*. It was influenced by the model of the VOC; but before long, the state assumed influence over the affairs of the company at the expense of the shareholders (Conac 2005). The King personally contributed one-fifth of the capital, decided on the distribution of dividends, and forced shareholders to make additional payments on shares. The French East India Company established factories in today's Réunion and Mauritius in the Eastern India Ocean and in Pondicherry in southern India. The French East India Company was dissolved in 1723. The company was, at most, a joint private–public enterprise like that of the Portuguese.

The Holy Roman Empire, in its Habsburg Court in Vienna, began in 1625 an initiative to form an East India Company. It negotiated with the Hanseatic cities and with the King of Spain. The proposed company was inspired by the models of both the EIC and VOC. But the endeavour was terminated in 1629 with the closure of the Hanseatic Diet (Amend-Traut 2012).

The Danish East India Company (*Dansk Østindisk Kompagni*, or OK) was established in 1616 and lasted until 1650 (Sørensen 2005). It was initiated by two Dutch immigrants from Rotterdam; its design influenced by the VOC model and its governance structure oligarchic. The Brandenburg Company, established in 1682, was Dutch-dominated, despite its Prussian base, and ended up being more involved in Africa than in Asia (Bergfeld 2005). It was succeeded in 1752 by the Emden Company that traded primarily with Canton in China. The Ostend Company was chartered in 1722 by the Habsburg King Charles VI. It was an Austrian–Flemish trading company for trade with the East and West Indies, and its capital was raised mostly from merchants in Antwerp and Ghent. It sent out 21 ships before suspending its activity in 1731 due to British political pressure. The Swedish East India Company (SEIC) was established in

1731 by a Scottish merchant, a former supercargo for the Ostend Company who wished to take advantage of the vacuum created by its liquidation. The base of the SEIC was in Gothenburg, and all incoming and outgoing ships had to go through that port. It traded mostly with Chinese goods, primarily tea.

The other European companies took the form of either the EIC or the VOC model. Some of the companies, the Portuguese, French, Habsburg, were formed in absolutist states in which the King was highly involved, expropriation was immanent, and companies were not really separated from the ruler (and did not take off). Some of the companies, the Danish, Brandenburg, Ostend and Swedish, were more of a platform for groups of interlopers from Britain and the Dutch Republic. They were operating in the 18th century environment of well-known routes and markets and routinized trade, in which the corporation was more of a rent-seeking monopolistic enterprise than an efficient enterprise using the joint-stock corporation form to cross entry barriers and engage in a trade otherwise inaccessible to individuals.

In Portugal, France and the Habsburg Empire the Crown was too absolutist and unconstrained and thus failed in establishing a long-lasting East India Company. In England on the other hand the nascent rule of law, manifested in the form of ancient constitution, Parliament and the common law courts, restrained the Crown (Harris 2013). Similarly, in the Dutch Republic the division of powers within the federal structure and the political partnership between the landed and commercial elites constrained the state. In Portugal, France and the Habsburg Empire there were no similar restraints on the Crown and this undermined the Crown's ability to credibly commit not to expropriate the privileges granted by the charter and assets of the passive investors once pooled together in East India Companies. Thus in most parts of Europe, with a notable exception in the form of England and the Dutch Republic, private passive investors were not willing to invest in large enterprises trading with Asia.

CONCLUSION

The EIC and the VOC were incorporated by state charter in 1600 and 1602 respectively. They were involved in similar business activities, namely oceanic trade in high-value goods between Europe and Asia, via the Cape Route (Brenner 1993). Both were organized as joint-stock corporations, with huge capital and hundreds of shareholders. The formation of the companies was a crucial juncture in the history of

business organizations and stock markets. The two entities were significantly larger, in terms of capital and number of shareholders, than any earlier merchant company in England or the Dutch Republic or anywhere else globally. They were much larger than any other Eurasian trade enterprise of the 17th and 18th centuries. They remained the largest business corporations of any sector in Europe for the next two centuries and served as the basis for the formation of the British and Dutch Empires (Prakash 1985, Chaudhuri 1965, Braudel 1982, Gelderblom, De Jong and Jonker 2013).

The environmental challenge faced by the English and the Dutch upon wishing to enter Cape Route oceanic trade with Asia was immense. They were located at the very far end of Eurasia, hence their shipping and trade costs and information-obtaining costs were the highest, and their turnover time was the longest among all Eurasian merchants. Given their latitude, the goods they could offer (sheep wool and Atlantic cod) were least in demand. They were the last to enter the trade and thus had to be able to cross significant entry barriers in the form of competitors and knowledge. They could not rely on rulers to fund their enterprise, either by way of taxes, as did the Chinese, or by a combination of taxes and sovereign borrowing, as did the Portuguese. Family firms and partnerships were not well suited for the task. A major institutional innovation was required in order to overcome these prohibitive environmental challenges.

The first essential building block for that innovative institution was the legal concept of corporate personality. This concept was well established in Europe by 1600. The corporation was by then recognized as a legal personality that was distinct from the individual and the family on the one hand and the Crown and the state on the other. This concept was formulated in late mediaeval Europe in order to provide for the constitutional needs of the Roman Catholic Church. It was developed as a platform for an immense organization that was at the same time highly hierarchical yet detached from any political ruler. The corporation provided longevity, device for asset pooling and the basic delegated governance structure.

The other key innovation that was formulated in the first few decades of the 17th century was financial. The joint-stock capital was a system of accounting and an investment tool. It was a tool for pooling together equity investment from hundreds of investors. It was also a system for splitting profits and bearing losses.

An essential pre-condition for the establishment of private or semi-private corporation with joint-stock of the scale of those of the EIC and VOC was a credible commitment by the state not to expropriate that

concentrated and liquid joint-stock. A fear from expropriation would prevent the pooling together of liquid assets of such a scale in the form of the joint-stock capital of these companies. In England a nascent rule of law promoted by the common law court and Parliament constrained the Crown. In the Dutch Republic it was the federal structure of the Republic together with the political clout of the merchant elites.

The marketing of shares, in the joint-stock was done not only on a personal basis, as was traditionally done, but also on an impersonal basis. Subscription was opened in public spaces and advertising was calling potential investors to join in. In both England and the Dutch Republic passive investors in their hundreds, often previously unconnected to overseas trade, often not relatives of the insiders, were willing to invest based on the institutional structure of the EIC and VOC and on their business prospects. This was a transformative moment in human history, from investment on a personal basis to investment on an impersonal basis.

The investment in the very long-distance Asian trade created a de facto lock-in of capital for one voyage that was soon followed by legal lock-in of capital for several voyages and for durations of a decade and more and eventually permanently. The lock-in of capital was mitigated by liquidity through a young and emerging secondary stock market. It was also mitigated by some level of voice in the form of voting rights and information flow in the form of accounts and reports in general shareholder meetings.

One should note that, contrary to some confusion in the historical literature, the modern doctrine of limited liability had not yet emerged at this stage. The EIC and VOC did not rely on debt finance and no conflict of interest between equity holders and creditors was in sight. Some degree of asset-partitioning could be assumed from the fact that the companies were legal entities that were separated from their members and no indication was given in the charters as to the right of creditors of members to dissolve ether the EIC or the VOC or to withdraw any of its assets.

The EIC and the VOC pushed forward the institutional cutting edge. They advanced due to necessity and through learning by doing and by failing, the modern joint-stock business corporation. Within a little over half a century the corporation that was hitherto used for various municipal and semi-public purposes was fully in use for business, for profit and long-distance trade purposes. The transformation integrated into the corporate form most of the basic features that are identified as those of the business corporation today.

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PART II

MODERN EUROPE

5. The development of English company law before 1900

John D. Turner

INDUSTRIALISATION AND BUSINESS ENTERPRISE

By 1900 England had the largest stock market in the world and was the leading industrial nation. Remarkably, freedom to incorporate as a limited liability company had been available only since 1855. Even more remarkable was the fact that England had undergone the Industrial Revolution without freedom of incorporation and with a legal framework which restricted the development of business organisation (Harris 2000). Indeed, most of the business enterprises which formed the backbone of the Industrial Revolution were sole traders, partnerships or unincorporated companies.[1] Therein lie two questions. Why was freedom of incorporation not a necessary precondition for industrialisation? And did the law respond to the socioeconomic pressures of the era or did it resist them?

In this chapter, we trace the evolution of company law in England before 1900. However, in order to do so, we need to identify what we mean by the company. The modern company or corporation has five basic legal characteristics: separate legal personality; limited liability; transferable joint stock; delegated management; and investor ownership (Kraakman et al. 2004, pp. 1–19). Legal personality is where a firm or organisation is permitted to act as a legal person distinct from its owners and managers. This enables firms to enter contracts more efficiently; sue and be sued in the name of the firm's designated officers; own real estate and assets; and pledge real estate and assets to creditors. Hansmann and Kraakman (2000) point out the importance of the affirmative asset-partitioning role of having a separate legal personality, which means that the assets of the firm are shielded from their owners and managers as well as the personal creditors of their owners and managers. Acheson et

[1] In UK parlance, 'company' is used rather than 'corporation'. The explanation for this is that England had for over a century companies which were unincorporated.

al. (2011a) emphasise that, without a discrete legal personality, it is very difficult to separate ownership from control and for a managerial hierarchy to be formed. Unlike most of the other features of the company, separate legal personality cannot be crafted by private contracting and is ultimately the gift of the State, contrary to the views of Anderson and Tollison (1983).

Delegated management is important because it lets third parties know who has the authority to make decisions and enter binding contracts on behalf of the firm. Investor ownership is the flip side of delegated management because it permits shareholders to have control rights and cash-flow rights without having to participate directly in the management of the firm. Limited liability for shareholders means that the creditors of the company are limited to making claims solely against the company and not against the assets of the individual shareholder. Transferable joint stock refers to the ability of owners to transfer their ownership shares to other individuals. The benefit of transferable joint stock means that a business can continue completely uninterrupted even though its underlying owners may change.

As we will see in the remainder of this chapter, the evolution of company law in England up to 1900 was all about the struggle to enable business enterprises to have all five of the core structural characteristics outlined above. The evolution of corporate law after 1900, however, was chiefly concerned with resolving the agency problems which arose out of conflicts created by the coming together of these characteristics, i.e., shareholders vs. managers, shareholders vs. shareholders and shareholders vs. other constituents (e.g., creditors and employees). Our focus in this chapter will be on the way in which these different characteristics evolved and combined in the 500 years before 1900 and the efforts of the legal system and the political elite to stifle the development of particular characteristics during most of this era.

IN THE BEGINNING …

The idea of the corporation as a legal fiction distinct from the individuals who compose it has an ancient history stretching back to the Romans, and possibly even earlier (Williston 1888). In England the ability of a grouping of individuals with a common interest to act as a corporate body with legal personality stretches back to the medieval period, with guilds and boroughs being granted incorporation charters which included: the right to sue and be sued; the right of perpetual existence; the right to own land; and the right to use a common seal, which verified that those

entering a contract with third parties were authorised to act on behalf of the corporate body (Cooke 1950, p. 21).[2] Thus, the early development of the corporate form was for local government, and incorporation was usually, though not exclusively, granted by the Crown. Indeed, this concept of the corporate form being used for public government persisted into the seventeenth century, with the plantation of Ulster undertaken by a corporation.

By the sixteenth century, there were numerous corporations in England apart from the guilds and boroughs, e.g., universities and colleges, hospitals, charitable bodies and ecclesiastical bodies. By this point also, the Crown had near-monopoly power over the creation of corporations and granted them through Royal Charters, letters patent or Acts of Parliament (Harris 2000, p. 17). But in none of these corporations was there the concept of a joint stock or capital, they simply united individuals who had a common interest. All of the business corporations which came after these early civic and ecclesiastical corporations differed from them in that joint-stock capital was added to the separate legal personality (Williston 1888, p. 149). The common interest of the individuals who contributed the capital was profit. Thus, instead of unifying a group of individuals, business corporations were created which agglomerated a capital fund and the legal system had to adapt to deal with the consequences emerging from this innovation in corporate technology.

The vast majority of companies which were created in the sixteenth century were mercantilist corporations which, as well as being incorporated by the Crown, were usually given monopoly trading rights with various countries. Indeed, monopolistic privileges were an integral part of these early companies, with the State implicitly or explicitly protecting the monopoly against competition from foreign merchants (Harris 2000, p. 41). They also were an attractive source of revenue for the Crown because, as a major source of the Crown's income, they allowed it easily to bypass Parliament. This was in an era when Parliament was questioning the prerogative of the Crown and these trading monopolies were also key institutions in foreign policy through their maintenance of embassies and military and naval facilities. Woodward (1985a, p. 12) rightly observes that it is 'shocking how non-laissez-faire are the roots of the corporation – a quintessentially laissez-faire institution'.

These early mercantilist companies came in two organisational forms – the regulated company and the joint-stock corporation. The main distinction between these two forms was that the former did not necessarily

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[2] On the history of the common seal, see Williston (1888, pp. 117–18).

have a transferable joint stock; the members of the company simply traded on their own account. With regard to limited liability, the members of the regulated companies did not possess it, and the members of joint-stock corporations did not derive this privilege from incorporation in and of itself – it existed only if expressly stated in the company charter, and was not necessarily at this time equivalent to modern conceptions (Harris 2000, pp. 128–9). However, like the joint-stock corporations, the regulated companies had most aspects of a separate legal personality and they had a hierarchical managerial structure. Neither of them, however, had necessarily a concept of perpetual existence – renewing their charters, indeed, was a source of extra revenue to the Crown.

The regulated companies typically had monopolies of trade with nearby countries, e.g., the Merchant Adventurers (est. 1505); the Spanish Company (est. 1577); the Eastland Company (est. 1579); and the French Company (est. 1609), while the joint-stock mercantilist corporations usually had monopolies of long-distance trade e.g., the Muscovy Company (est. 1555); the Levant Company (est. 1581); and the East India Company (est. 1599). Subsequently, the Muscovy Company and Levant Company were reorganised as regulated companies.

The business corporation flourished in the first two decades of the seventeenth century – about 40 (mostly regulated) companies were formed and were granted monopoly trading rights across the globe, their total membership coming close to 10,000 (Harris 2000, p. 45). However, for the rest of the century until the Glorious Revolution of 1688, the business corporation suffered a demise. The major cause was the abuse of the monopoly trading privileges by James I (r. 1603–25) and Charles I (r. 1625–49).

James I, a spendthrift and heavily indebted, sold exclusive trading charters; in order to raise further income, he renegotiated, and even reneged on, existing ones. This created investment uncertainty and provoked the ire of Parliament, which in 1623 passed the Statute of Monopolies, with the aim of curtailing the ability of the Crown to sell new monopolies. However, this Act was full of loopholes, which were fully exploited by Charles I when he acceded to the throne (Harris 2000, p. 47). Charles I salami-sliced the domestic and international economic activity of the nation and sold it in the form of monopoly franchises. However, weak enforcement and expropriation by the Crown meant that the franchise value of charters fell quite dramatically. The status of the public company did not recover during the Interregnum (1649–60) or the Restoration (1660–88) and the rise of alternative sources of public finance meant that there was a much-reduced incentive for the Crown or

Parliament to raise finance via granting monopoly charters. The only exceptions in this period of decline were the Hudson's Bay Company (est. 1670), which had a trade monopoly over the Hudson Bay area, and the Royal African Company (est. 1672), which was granted a monopoly on the slave trade between Africa and the West Indies.[3]

Two milestones in the evolution of the public company were reached in the seventeenth century with the East India Company.[4] First, this company, by raising capital from nearly 1,000 investors for its 1617 voyage to the Indies, opened up investment in companies to the general public – 'the company investor had arrived' (Cooke 1950, p. 58). Second, in the 1650s, it raised a permanent and perpetual joint stock (Neal 1990, p. 45). Up to this point, its capital had been ad hoc, with voyages and ventures being financed individually and temporary joint stocks, which enabled investors to demand all their capital back.

The Glorious Revolution of 1688 ushered in major constitutional changes, which had a major positive effect on the development of the corporation and capital markets (North and Weingast 1989). The large fiscal needs of the new State resulted in the expansion of public debt and the creation of two companies which played a major role in public finance – the Bank of England (est. 1694) and the South Sea Company (est. 1711). Half of the Bank of England's £1.2 million of capital was lent to the State and it continued to lend money to the State thereafter. It also facilitated the raising and administration of the public debt. A proportion of the South Sea Company's capital was also exchanged for national debt. Although it was initially given a monopoly of trade with parts of South America, it soon moved away from this and transformed itself into a company which focused on financing the State. The East India Company also got into the act and invested heavily in the national debt. By 1714 these three companies between them were holding 39 per cent of the national debt (Dickson 1967, p. 80). The seeds of the first financial bubble had been sown.

THE BUBBLE ACT

The financial revolution that accompanied the Glorious Revolution resulted in 1693 in the development for the first time of a permanent government debt. Trading in these new government debt instruments and

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[3] See Carlos and Kruse (1996) and Carlos and Nicholas (1990) on agency and other problems within these two companies.

[4] On the East India Company, see Baskin and Miranti (1997, pp. 63–82).

in the shares of the three large moneyed companies (the Bank of England, South Sea Company and East India Company) and many other companies expanded substantially – the birth of the London stock market dates back to the 1690s. By 1695 there were circa 150 companies with a capital of £4.3m and in 1704 the turnover of shares in the Bank of England and East India Company totalled £1.8m or 85 per cent of their combined capital (Michie 1999, pp. 15–16). The new companies in 1695 were from various sectors: banking and finance, fishing, manufacturing, mining and water supply. However, many of these companies were short-lived, and by 1717 circa 12 companies were traded on the London stock market, where trading was dominated by the three moneyed companies listed above (Harris 2000, p. 58).

In the late 1710s there was increasing speculative activity on the London stock market. But the rationale for what has become known as the Bubble Act was not the quelling of this speculative activity, or the preventing of future bubbles by banning unincorporated companies from forming. Indeed, this somewhat misleading appellation was only given to the Act in the early nineteenth century. It was misleading because the Act had little to say about speculation and bubbles in company formation and because the first financial bubble was largely concentrated in the moneyed companies, particularly the South Sea Company. It was also misleading because the Act was conceived by a parliamentary committee in February 1720 and passed on 11 June 1720, two months before the South Sea Bubble even showed signs of bursting.

The chief purpose of the Bubble Act was to limit alternative investment opportunities so that capital would be diverted towards shares in the South Sea Company. Harris (2000) provides compelling evidence that the South Sea Company was the main instigator of the legislation and that the incentives of the ruling elite were closely aligned with the South Sea Company because many of its members had invested in it. Moreover, the company was helping to refinance the substantial public debt which had accumulated in the two decades after the Glorious Revolution, and which in the relatively peaceful 1710s was paying interest at a rate of 2–4 per cent above the market rate. The scheme devised by the South Sea Company enabled it to operate a debt-for-equity conversion whereby subscribers could buy shares in the company using government bonds. The company then refinanced the debt at a lower interest rate and paid the government a substantial fee for the privilege of carrying out the debt-for-equity conversion. This scheme was made attractive by the continuous good news being released about the South Sea Company, which increased investor expectations regarding future profits and in turn pushed up the company's share price.

Between October 1719 and July 1720, the company's share price increased 820 per cent. The prices of the two other moneyed companies also increased – the Bank of England's went up 170 per cent and the East India Company went up 220 per cent. In addition, the speculative fervour in the stock market attracted hundreds of small 'bubble' companies which were unincorporated and had no State permission to form as companies. The estimated total capital of these companies (circa £250 million) was such that they threatened to undermine the debt-for-conversion operation being operated by the South Sea Company. The Bubble Act was passed not because these unincorporated companies were of dubious legality, but rather because they threatened to divert substantial capital away from the South Sea Company.

A secondary purpose of the Act, and one which was added to the Act late in the day as it passed through parliamentary committees, was that it incorporated two marine insurance companies (London Assurance and Royal Exchange Assurance), giving them a monopoly of marine insurance. The chief reason for granting this monopoly was that each company offered to pay £300,000 of the King's debt.

The South Sea Bubble has been referred to as the first financial bubble and it marks a major point in the development of publicly-traded companies and the stock market. But why did it occur? Explanations for it fall into several categories. First, ever since Mackay (1856), many have blamed mania, popular delusion, the madness of the crowd and irrationality. Second, Kindelberger (2000), Neal (1990) and Giusti et al. (2013) put the blame on the large-scale debt-for-equity conversions. Third, Frehen et al. (2013) suggest that major innovations in finance, trade, maritime insurance and the corporate form fuelled investor expectations, causing the asset price reversal which has been associated with similar technological revolutions (Pástor and Veronesi 2009).

What were the long-run effects of the Bubble Act? The popular yet mistaken belief is that the Act hindered the development of the corporate form in England and set financial capitalism there back by a century. To tell the truth, the effect of the Bubble Act was negligible at best. First, before the passage of the Act, unincorporated companies were not recognised as such by the common law. The passage of the Act therefore changed nothing. Second, the Act was a dead letter – only one prosecution in the eighteenth century took place under it. Third, thanks to legal ingenuity, many unincorporated companies were established in the 1700s, notwithstanding the Act (Cooke 1950, p. 84).

THE PARTNERSHIP AND THE UNINCORPORATED COMPANY

Despite the passage of the Bubble Act, within a few decades the Industrial Revolution was well and truly under way in England. How did the businesses at the core and periphery of the Industrial Revolution organise themselves? The dominant form of organisation was the partnership. In two of its rulings, the Courts of Chancery created what is known as the 'jingle rule'. In the 1683 case of *Craven v. Knight*, it was ruled that the creditors of a partnership had first call on the assets of a bankrupt partnership, and only after they had been satisfied could any surplus be made available to personal creditors. Subsequently, in 1715 in *Ex parte Crowder*, Chancery ruled that a partner's personal creditors enjoyed first call on his personal assets and that partnership creditors had a claim on personal assets only after personal creditors had been paid. Although these rules created what Hansmann et al. (2006) called weak entity and owner shielding, the English partnership form suffered from the problem of untimely dissolution and the associated opportunism and hold-up costs (Lamoreaux 1998; Acheson et al. 2011a). These costs meant that partnerships tended to be small and between individuals with close social or familial connections. As a result, they were an unsuitable organisational form for businesses with large capital needs.

Business enterprises which had large capital requirements and therefore required a relatively large number of owners and tradable ownership stakes resorted to the organisational form of the unincorporated company. This form emerged when the trust form was applied to the partnership. The enterprise's assets (including land) were held in a trust by trustees who were appointed by the partners. This meant that the partners or stockholders could sell their shares because the trustees stayed the same. To what extent did these entities have a separate legal personality, limited liability, transferable joint stock, delegated management and investor ownership?

The deeds of settlement, which were the constitutional documents of unincorporated companies, prevented shareholders from entering binding contracts or acting in a managerial capacity. These business entities therefore had delegated management and a separation of ownership from control, with directors or managers being appointed by the owners following the regulations laid out in the deed of settlement. However, unlike third parties with corporations, third parties with unincorporated companies could not be certain whether a particular person had authority to act on behalf of all the other owners. Unincorporated companies also

ran into difficulties when they came up against the common law because it ignored deeds of settlement and viewed unincorporated companies as mere partnerships. This meant that all shareholders were treated as partners and named as plaintiffs or defendants when it came to suing or being sued. There was thus a tension between what was possible in equity law in the Court of Chancery and what was possible in common law, which resulted in unincorporated companies not having a separate legal personality.

The Bubble Act was ultimately concerned with preventing the establishment of corporations with freely transferable shares. In order to keep unincorporated companies outside the ambit of the Bubble Act, deeds of settlement included clauses which required trustees to give prior approbation before shares could be transferred (Cooke 1950, p. 99). In other words, although shares in unincorporated companies could be transferred, they could not be transferred freely.

Some unincorporated companies, particularly those towards the end of the eighteenth century, claimed to have limited liability and contracted to have limited liability in their deeds of settlement. Insurance companies, in particular, contracted so as to have limited liability (Supple 1970, p. 118). However, much uncertainty surrounded this issue, particularly in the case of insurance companies. Although the Courts of Chancery upheld the limited liability clauses in deeds of settlement, under the common law, unincorporated companies were *de jure* and *de facto* unlimited (Macgillivray and Browne 1937, p. 3). Ultimately, unincorporated insurance companies could limit their liability *inter se*, but not to third parties (Harris 2000, p. 143), and investors even doubted the claims of insurance companies that they had limited liability (Raynes 1948, p. 211). From a practical point of view, unincorporated insurance companies had such large amounts of uncalled capital (i.e., capital which could be called upon by directors and creditors) that their liability status was almost immaterial (Acheson et al. 2012).

Did the ingenuity of lawyers and the Courts of Chancery create in the unincorporated company an organisational form which was *de facto* a corporation? If this is the case, then the introduction of general incorporation in the nineteenth century was simply a matter of the law following common business practice. In addition, if it is true, then the unincorporated company is a prime example of the flexibility of the English legal system to meet the demands of a rapidly changing business and industrial environment. However, Harris (2000) suggests that this organisational form faced two major problems, which meant that it was far from being the corporate form and its achievements were moderate at best.

First, the lack of a separate legal personality made litigation a very costly exercise. Indeed, after 1807, a number of unincorporated companies (mainly insurance companies) obtained Acts of Parliament to enable them to sue and be sued in the name of a company officer. By 1815, 30 such Acts had been passed (Harris 2000, p. 165) and the greatest growth in the number of unincorporated companies coincides with the passing of this legislation (Freeman et al. 2012, p. 15).

Second, the Bubble Act cast a continual shadow over the unincorporated company, making their legality questionable. Furthermore, they could not find a legal arena that dealt quickly enough with internal disputes. Chancery was a one-man court until 1813 and, as a result, things moved very slowly and the Lord Chancellor was uninterested in internal disputes between partners and trustees (Harris 2000, p. 164). In addition, Chancery fees were very high.

THE CORPORATION IN THE EIGHTEENTH CENTURY

With the development of corporations and transferable joint stock arose legal questions which came before the courts. Several cases concerned the issues of whether shares in joint-stock companies were realty or personalty; what to do about stock in the company transferred without the consent of their owner; and what to do if the company refused a transfer (Williston 1888, pp. 150–56). In terms of company bylaws, there were attempts by large shareholders to circumvent one-shareholder-one-vote voting rules, which were commonplace in early joint-stock companies, by the practice of splitting stock, i.e., temporarily transferring shares to friends to increase one's voting power. The Public Companies Act (1767) was passed to prevent this practice by requiring that members of public companies who had not held the stock for at least six months were ineligible to vote.

The practice of paying for stocks in instalments when they were first issued was commonplace among early joint-stock companies and persisted well into the nineteenth century. Disputes came before the courts regarding the non-payment of calls and whether or not an original subscriber could avoid liability by selling his stock. In *Child v. Hudson's Bay Company (1723)*, it was made clear that a shareholder must pay calls when required to do so or forfeit some of his stock for non-payment; but it was not until *Huddersfield Canal Company v. Buckley (1796)*, that the assignment of a stock was established as transferring the liability for calls to the new owner.

It is not clear how far the owners of joint-stock companies were liable for the debts of their company before circa 1800. In the case of the *City of London (1680) I Ventr. 351*, it was stated that the responsibility of owners for the debts of the corporation were inconsistent with the concept of the corporate body. However, this did not necessarily let owners off the hook because a company unable to pay its debts could be legally required to make calls upon its members to enable it to pay its debts. For example, in the 1671 case of *Dr Salmon v. The Hamborough Company*, it was ruled that the members of the company were indirectly liable for its debts because its charter gave the company power to make calls on its owners. In the 1673 case of *Naylor v. Brown*, it was ruled that the members of the company who were also creditors of the company ranked below other creditors. Apart from these cases, what limited liability actually meant in the seventeenth and eighteenth centuries remains fairly incoherent (Cooke 1950, p. 77; DuBois 1938, pp. 93–5; Harris 2000, p. 129).

By the early 1800s, there was much more clarity about what limited liability actually meant, that: (a) calls could be made on members only if call-making power had been granted to the company; (b) incorporation by Royal Charter or Act of Parliament carried with it limited shareholder liability; and (c) owning shares did not turn non-traders into traders, and thus expose them to draconian (i.e., debtors' prison) bankruptcy laws, which applied to traders only. In the late eighteenth century, there was correspondingly a greater desire for limited shareholder liability from those looking for corporate status – it even became a major motive in seeking incorporation (DuBois 1938, pp. 95–9).

Most businesses seeking incorporation in the second half of the eighteenth century sought to do so via a private Act of Parliament rather than a Royal Charter. In particular, a large number of canals were incorporated by private Acts – over 100 canals by 1800, with nearly 80 of these formed during a promotion boom in the early 1790s (Ward 1974). These canal companies had a transformative effect in that they familiarised parliamentarians with the corporate form (Harris 2000, p. 100). In addition, canals contributed to the growth of capital markets because their shares were traded on primary and secondary markets. In a sense, they blazed the trail for the large diffusely-owned companies which would emerge in the nineteenth century.

FREEDOM OF INCORPORATION

By 1800 entrepreneurs who wanted to form a business enterprise had three choices: (a) set up as a partnership; (b) operate as an unincorporated company; or (c) incorporate via a Royal Charter or private Act of Parliament. However, there were two industries which operated outside the common law and did not have to resort to the unincorporated organisational form – shipping and the Cornwall and Devon stannary mines.

Shipping came under the jurisdiction of the High Court of Admiralty and, as a result the organisational form for shipping took a different development path. Ship ownership was divided into equal parts, and ships had sleeping partners, transferable ownership, delegated managerial authority and partial limited liability (Harris 2000, p. 190).

The Cornwall and Devon tin mines operated under the jurisdiction of the Stannary Courts, which stretched back to the Middle Ages. Stannary mines operated a cost book system, which gave them flexibility in terms of raising new capital and paying dividends on a frequent basis (Bartlett 1850). These mines operated as entities separate from their owners and had managerial hierarchies as well as tradable shares. In principle, although they had unlimited liability, there were procedures in place (mainly placing limits on a mine's ability to borrow) which resulted in owners (or adventurers) having some control over the extent of the mine's liability (Burke and Richardson 1981; Burt and Kudo 1983).

The first quarter of the nineteenth century brought various pressures on Parliament with regard to businesses and their incorporation. A combination of increasing trade, the growth of new industries, the growth of cities and towns, and the rise of a new investing public that had amassed substantial savings resulted in increased company promotions. This came to a head in the 1824–25 boom, when 624 companies were floated on the London stock market (English 1827, p. 30). Questions regarding the legality of these companies resulted in 438 requests to Parliament for the formation of corporations; Parliament gave 286 of these their own act of incorporation (Harris 2000, p. 255). At the height of this promotional frenzy, the Bubble Act was repealed on 5 July 1825.

The subsequent crash and fallout from the collapse of the promotional boom and the collapse of the English banking system resulted in a serious financial crisis, which brought about a reform of banking incorporation law in England because, it was believed, the existing structure of English banking had been a key contributor to the banking collapse (Turner 2014, p. 108). At the time the Bank of England had a

monopoly; other banks were explicitly limited to being partnerships and note-issuing banks were forbidden to have more than six partners. The crisis was brought to an end when the Bank of England, under pressure from the Treasury, acted as a lender of last resort (Turner 2014, pp. 144–5). As a result, the Banking Copartnerships Act (1826) was passed, which gave banks freedom to incorporate as unlimited liability companies, provided that they were located outside a 65-mile radius of London. The Bank of England Privileges Act (1833) allowed non-issuing joint-stock banks within this radius, thus ending the Bank of England's monopoly.

The repeal of the Bubble Act had the effect of increasing the legal uncertainty surrounding the unincorporated company. Unincorporated companies now came under the purview of the common law, and opposing and contradictory judgments confused matters. Some judges would declare an unincorporated company legal, but other more conservative judges, who were in the majority, would declare it illegal (Cooke 1950, p. 106; Harris 2000, p. 249).

This untenable state of affairs meant that Parliament had to intervene in order to reform incorporation law. Reform came in the shape of the Joint Stock Companies Registration and Regulation Act (1844). Incorporation was obtained through registration – provisional registration was required before shares could be offered publicly and full registration was required a year thereafter – and the deposit with the Registrar of Companies of a deed of settlement being signed by at least one-quarter of the shareholders holding one-quarter of the shares. Once registration was completed, companies enjoyed all the features of a modern corporation apart from limited liability. They could even sue and be sued in the name of designated officers and they could hold land in the company's name. Thus this Act was revolutionary in that 'for the first time in at least 500 years corporations could be formed without explicit, deliberate, and specific State permission' (Harris 2000, p. 284). Notably, because the Act ruled that all partnerships with more than 25 members and freely transferable shares had to register, it effectively extirpated the unincorporated company. However, companies which had been incorporated before the Act came into being did not fall under its purview. The Joint Stock Companies Registration and Regulation Act (1844) also did not apply to insurance and banking companies; banks had their own Act – the Joint Stock Bank Act (1844) – which specified that each new bank with more than six partners had to obtain a charter or letters patent in order to conduct its business. Charter duration could be no more than 20 years and banks were subject to onerous chartering stipulations. As a result,

very few (if any) new banks formed under this legislation (Turner 2014, pp. 39–40).

The Joint Stock Companies Registration and Regulation Act (1844), furthermore, did not apply to companies such as railways and public utilities which required powers of compulsory land purchase and hence required parliamentary approval to go about their business. These companies were incorporated via parliamentary private incorporation bills, which meant that company constitutions and governance provisions had to be separately inserted into every bill. The 1845 Companies Clauses Consolidation Act prescribed the governance and shareholder protection rules that had to be included in future statutory incorporations. The preamble to the Act stated that it was necessary to avoid repeating the provisions in parliamentary incorporation acts to ensure greater uniformity. The Act contained a common deed of settlement which applied to all subsequent statutory incorporations.

What were the economic effects of the Joint Stock Companies Registration and Regulation Act (1844)? Within 14 months, 1,639 provisional registrations had been made, and by the time the next step in the liberalisation of company law was taken in 1856, there were 956 complete registrations and 3,942 provisional registrations (Harris 2000, p. 288). However, it is unknown how many of the provisional registrations in 1844 and complete registrations in 1856 were new businesses seeking incorporation and how many were existing unincorporated companies simply coming under the provisions of the Act. In addition, the 1844 Act contributed little to the growth of public companies and the UK equity market (Acheson et al. 2009). The growth of the equity market from 1844 onwards and the opening of provincial stock exchanges in the mid-1840s was primarily driven by railways and joint-stock banks, which, as noted above, were not incorporated under this legislation.

In the period from the 1810s to the 1840s, the company form became more commonplace and the total capitalisation of the equity market grew from being less than 5 per cent of GDP to being more than 20 per cent of GDP (Acheson et al. 2009). This growth was largely due to the greater liberality of Parliament in granting corporate status (railways, public works, gas-light companies, etc.) and the liberalisation of banking incorporation law. Importantly, in this era, the connection between monopoly and the business corporation was broken with the ending of the East India Company's monopoly on trade with China and India, the ending of the monopoly on marine insurance in 1824 and the significant paring back of the Bank of England's monopoly as a result of the liberalisation of banking incorporation law in 1826 and 1833.

THE ARRIVAL OF LIMITED LIABILITY

The 1844 Act had given businesses formed under it every aspect of corporate status apart from limited liability. In 1855 an Act for 'Limiting the Liability of Members of Certain Joint Stock Companies' was passed by Parliament, but was quickly repealed. The Act was re-enacted in 1856 as 'An Act for the Incorporation and Regulation of Joint Stock Companies, and other Associations'. These two Acts enabled businesses upon registration to incorporate as limited liability companies. Banks and insurance companies were initially excluded from the limited liability acts, but limited liability was extended to banks under legislation passed in 1858, and insurance companies received this privilege by their inclusion in the 1862 Companies Act. The 1862 Companies Act was a consolidation of existing pieces of legislation and it was the progenitor of all future Companies Acts in the UK. The 1862 Act marks the final step in the centuries-long evolution of the corporate form in the UK. Every business could now avail itself of all of the features of incorporation through a simple registration process.

The effect of the liberalisation which took place in 1855 and 1856 was huge – nearly 5,000 limited liability companies had been established in England by the end of 1856 (Shannon 1933). The effect on the equity market was also substantial, but took some time to come to fruition, and it was only following a promotion boom in 1862 that the effect began to be noticed on the stock market (Acheson et al. 2009). However, the growth of the stock market in terms of issues and value in the second half of the nineteenth century (see Grossman 2002) would not have been possible without the liberalisation of incorporation law.

Interestingly, banks which had been established under the Banking Copartnerships Act (1826) could re-register under the 1862 Act. The main purpose of so doing would have been to limit shareholder liability. However, by the 1870s, there were still circa 70 English banks which were companies with unlimited shareholder liability and shares traded on stock markets (Turner 2014, p. 41). Only seven English banks took advantage of the 1862 Act. Why did banks not take advantage of the Act and convert to limited liability? Ultimately, bank shareholders and depositors believed that unlimited liability made for a more stable banking system because the liability on shareholders was an effective constraint on risk shifting and excessive risk taking (Turner 2014, p. 124–5). However, the collapse in 1878 of the City of Glasgow Bank, At the time one of the largest unlimited liability banks in the UK, resulted in a change of attitude, particularly among bank shareholders

(Acheson and Turner 2008). Subsequently, a Companies Act was passed in 1879 to facilitate the limitation of liability by banks. This Act created the concept of reserve liability, which meant that banks could have extended liability, but less than unlimited liability. For example, some banks had double liability (i.e., for every £100 of capital shareholders had paid in, they were liable for another £100) and others had various multiples of paid-up capital. This reserve liability could be called up only in the event of a bank's failing, unlike uncalled capital which also could be called up at the discretion of directors. All banks quickly limited their liability after the passage of the 1879 Act, but reserve liability remained a feature of British banking until the mid-1950s (Turner 2014, p. 132).

The presence of unlimited liability in English banking companies until the 1880s raises an interesting question as to whether limited liability was a prerequisite for share tradability. Many scholars believe that any extension of liability beyond limited liability raises the costs of trading stock to such a degree that limited liability is a prerequisite for share tradability (Alchian and Woodward 1987; Carr and Mathewson 1988; Halpern et al. 1980; Winton 1993; Woodward 1985b). However, evidence from English banking would appear to contradict this view because the shares of unlimited liability banks were traded on public markets, and trading activity and liquidity did not change when banks limited their liability (Acheson et al. 2011b). Thus, limited liability may not have been as important for the development of the public corporation as scholars believe.

The 1862 Companies Act provided little in the way of protection for shareholders (Campbell and Turner 2011). The model set of articles in Table A of the 1862 Act, which if adopted provided high levels of protection, were only default rules and 99 per cent of companies chose to ignore them (Acheson et al. 2016; Edwards and Webb, 1985). Common law judges, largely influenced by laissez-faire theory and the practice of partnerships, did not believe that the courts should intervene in internal company matters in order to protect shareholders (Acheson et al. 2016). This brings up the question as to how companies raised capital on public markets from a diffuse range of investors. One possibility is that weak shareholder protection resulted in concentrated ownership. However, recent scholarship has revealed that the ownership of public companies in the post-1862 era was by modern-day standards diffuse (Acheson et al. 2015).[5] This is contrary to the law and finance hypothesis which suggests

[5] On the issue of investor protection and corporate ownership in Victorian and Edwardian Britain, see Campbell and Turner (2011); Cheffins (2001, 2008); Cheffins et al. (2013); Foreman-Peck and Hannah (2012, 2015); Franks et al. (2009).

that the strong protection of shareholders is a prerequisite for diffuse ownership (La Porta et al. 1998, 1999). How was diffuse ownership possible in such an environment? One possibility is that companies voluntarily inserted clauses into their articles of association which offered outside shareholders a great deal of protection (Acheson et al. 2016). Another possibility is that capital markets kept companies on a short leash by requiring them to pay out most of their earnings in the form of dividends (Campbell and Turner 2011).

The liberalisation of incorporation law and the Companies Act was premised on the idea that incorporation would be sought by large enterprises with substantial capital needs. However, in the decades after liberalisation, incorporation became increasingly common for small enterprises, not with the aim of raising capital from the public, but to avoid the costs associated with untimely dissolution and to facilitate the intergenerational inheritance of businesses (Harris 2013). Under the Companies Act (1862), seven was the minimum number of shareholders that a company could have, but there was nothing to prevent sole traders from setting up a company with six nominal shareholders. Indeed, the legality of this type of company came under question in the famous case of *Salomon v. Salomon* – Aron Salomon had turned his sole proprietorship enterprise into a company with 20,000 shares, with six of his family being fellow shareholders holding one share each. The concept of the private company was introduced into company law in the Companies Act 1907, which settled the issue surrounding nominal shareholders and defined a private company as one which committed in its articles not to raise capital from the public.

EXPLAINING THE EVOLUTION OF COMPANY LAW

At the start of this chapter, we posed two questions. Why was freedom of incorporation not a necessary precondition for industrialisation? Did law respond to the socioeconomic pressures of the era or did it resist them?

England experienced the Industrial Revolution without the freedom of incorporation. Hansmann et al. (2006) suggest that partnership law, with weak entity and owner shielding and unincorporated companies, meant that the lack of freedom to incorporate was not a big deal. However, we saw above that the achievements of the unincorporated company were limited due largely to their questionable legality. Another possibility is that family firms, sole proprietorships and partnerships sufficed to meet the capital and organisational needs of the business enterprises at the time. Related to this argument is that English wealth was highly

concentrated in the hands of the elite (Lindert 1986). In other words, incorporation was not needed to raise capital from a large number of investors because wealth was concentrated in the hands of the few. However, one has to ask counterfactually what the Industrial Revolution would have been like with freedom to incorporate, particularly from the perspective of efficient organisational design which overcomes issues of untimely dissolution.

According to Harris (2000), the responsiveness of the legal system and lawmakers in Parliament to socioeconomic forces varied over the period under consideration in this chapter. In the age of discovery and Empire building, the Crown and Parliament were liberal in incorporating trading companies. However, under the Stuarts, this was heavily abused. After the Glorious Revolution, there appeared to be greater liberality with respect to incorporations and the establishment of unincorporated companies. However, the South Sea Bubble and the Bubble Act resulted in a changed attitude towards incorporation and the unincorporated company. Parliament incorporated very few companies and the common law judiciary was hostile to the unincorporated company. The conservative common law had been greatly empowered thanks to the Glorious Revolution and the financial market speculation of 1720 only strengthened its opposition to the unincorporated company. Although there were attempts to undermine or bypass the common law through the Court of Chancery and the use of the trust mechanism to create unincorporated companies, this organisational form was not a successful surrogate.

The nineteenth century brought pressures upon legislators which made the liberalisation of incorporation necessary. First, the capital needs of large infrastructure projects such as railways could be met only by aggregating the funds of many investors. Consequently, Parliament became much more liberal in granting incorporation to such businesses. Second, the increasing wealth of the middle classes created a demand for alternative outlets beyond government debt and annuities for their surplus capital (Jefferys 1977). The increased political power of the middle classes in the nineteenth century at the expense of the landed elite meant that the political calculus in Parliament changed, with the result that incorporation law was liberalised by granting freedom of incorporation with limited liability.

Finally, a major debate in the law and economics literature is whether common law legal systems are superior to their civil law counterparts (La Porta et al 1999, 2008). One of the arguments as to why common law is superior is that it is inherently dynamic and pragmatic in responding to new business environments and opportunities. However, the common law judiciary in the eighteenth and nineteenth centuries was extremely

conservative and did not respond in a dynamic fashion to the new business environment which had arisen. Ultimately, it required parliamentary intervention via statutes to promote the development of the corporation (Musacchio and Turner 2013, p. 535).

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6. Shareholder primacy, labour and the historic ambivalence of UK company law

Marc T. Moore

1 INTRODUCTION

Recent comparative legal scholarship has sought to underscore the apparent 'deep ambivalence' of the United States' corporate law framework relative to its British counterpart (Bruner 2013: 37). Whereas the former system – it is claimed – 'remains deeply ambivalent regarding the intended beneficiaries of corporate production, and their relative priority under varying circumstances' (Bruner 2008: 1424), in the latter system, by contrast, 'shareholder wealth clearly represents the defining aim of the corporate enterprise' (Bruner 2013: 36–7). Moreover, while the purported ambivalence of US corporate law's juridical articulation of the proper corporate objective is something of a contested issue today (Strine 2015; Austin 2016), the corresponding *unambivalence* of UK company law in this regard is largely unquestioned. Indeed, few commentators would have cause to quibble with Professor Bruner's articulate observation that 'with respect to what directors are actually expected to do – that is, the values and interests that are to drive their decision making – [contemporary UK company law] makes clear that shareholders are to be first and foremost in their minds' (Bruner 2013: 34).

Although frequently taken for granted today, the lexical priority that the British company law framework affords to the interests of shareholders over those of other corporate constituencies is remarkable, not least when viewed alongside the correspondingly disempowered corporate governance status of labour in the UK. Indeed, on first reflection it is somewhat curious that the interests of employees have not figured more prominently within British company law, especially when one considers the general political disposition of the country in modern times. Throughout the course of the last century, the UK has witnessed 37 years of Labour government (or 42 years if one includes Labour's participation in the wartime coalition government). And although the UK is acknowledged on the whole as having a more neo-liberal (i.e. right-wing) political orientation than many of its northern European counterparts

(Roe 2003), it nonetheless has a comparatively strong social-democratic (i.e. left-wing) political tradition in relation to other English-speaking and former-Commonwealth countries, at least since the Second World War (Bruner 2013; Cheffins 2002). It is thus not unreasonable to expect that, at some point during the post-war era, democratic public policy measures might have been taken to effect the direct integration of worker interests into the heart of the British corporate legal structure.

The apparent persistence of shareholder primacy in the UK throughout modern times is made even more striking by the fact that numerous other major European company/corporate law systems have traditionally vested employees with a formal share of corporate decision-making power at board level, most of which continue to do so today (Conchon 2013). This demonstrates that – contrary to what some Anglo-American commentators have previously averred (Hansmann and Kraakman 2001) – purely shareholder-oriented models of company/corporate law are from an international standpoint neither functionally inevitable, nor innately superior to the available alternatives. Furthermore, it is not readily apparent from the UK's historic industrial performance that the country's shareholder-centric corporate governance paradigm has been conducive to any material comparative advantage over more labour-oriented 'competitor' systems. Nor would it seem that the characteristics of Britain's key industrial sectors are sufficiently distinct from those of her continental-European counterparts to justify the adoption of such a markedly differing national company law regime, at least absent other operating causes.

However, while the centrality of shareholders' interests to the doctrinal and normative fabric of contemporary UK company law is both manifest and incontrovertible, this has curiously not always been the case. Rather, with respect to the fundamental question of the proper corporate objective – that is, as to whose interest British company directors are expected to serve while carrying out their functions – UK company law up until 2006 adopted a highly ambiguous position, indeed arguably even *more so* than US corporate law. Admittedly, the related issue of which constituency should be allocated determinative control over the corporate board has, by contrast, consistently been settled in favour of a shareholder primacy position in the UK. A less well-known fact, though, is that British company law has in the fairly recent past come precariously close to adopting a radically different board representation model, in which worker interests would formally have *shared* centre-stage with those of shareholders in a similar vein to the traditional German corporate governance model.

Somewhat ironically, as will be recounted below, one of the principal impediments to the practical realisation of pro-worker UK corporate governance reforms in the twentieth century was the longstanding antipathy of much of the British labour movement itself towards the implementation of European-style employee involvement mechanisms. Indeed, UK trades unions – in contrast to many of their continental-European counterparts – for a long time exhibited a general preference for 'external' engagement of employees with employer firms via collective bargaining and other such inherently adversarial forms of industrial action, over 'internal' corporate governance reforms aimed at incorporating employees' interests into core corporate decision-making processes. However, both general labour market conditions and prevailing union attitudes have changed considerably in the intervening period, such that a revisiting of these issues is arguably called for today.

Accordingly this chapter's principal positive claim is that, while UK company law might (rather like Mount Vesuvius!) look substantively stable and well-settled on its surface today, on closer inspection this façade of apparent calm can be seen to mask a fairly recent history of doctrinal and ideological turbulence with regard to fundamental underlying concerns. The chapter's ensuing prescriptive insight, meanwhile, is that there is cause to question whether the basic normative impetus of the UK's company law framework is as complementary to its surrounding economic and socio-political context as might first appear. Relatedly, one might justifiably query the long-term sustainability of the shareholder primacy position within British company law, particularly in the light of contemporary demographic trends which suggest a developing deficit of popular public support for preserving the UK's traditionally shareholder-centric corporate governance paradigm.

2 THE DOCTRINAL FOUNDATIONS OF SHAREHOLDER PRIMACY IN UK COMPANY LAW AND CORPORATE GOVERNANCE

Most directors and senior managers of UK companies would likely regard it as trite law that, in undertaking their managerial and/or control functions, they are accountable first and foremost to their employer firm's general body of *shareholders*. This is generally perceived to demand that such officers render dutiful service to the collective shareholder interest, which ordinarily entails generating an optimal (or, at least, relatively high) financial return for shareholders whether as measured on a short- or

long-term basis. It correspondingly follows that the interests of other corporate constituencies – and, in particular, those of employees – must ultimately cede to those of shareholders in the event of conflict.

But while shareholders' lexical supremacy over employees from the perspective of a corporation's management is typically taken as gospel, it is at first sight rather less clear *from where* shareholders' relatively privileged governance status in this regard formally derives. In other words, how is the general governance supremacy of shareholders (particularly in relation to employees) within UK companies *legally constituted*? As will be explained below, while there is no single formal legal doctrine of 'shareholder primacy' in UK company law as such, there are nonetheless an important collection of legal rules and principles which mutually establish this functionally significant corporate-managerial norm. These provisions essentially affirm: (i) shareholders' status as the ultimate collective beneficiary of the director's fiduciary duty of loyalty; and (ii) shareholders' exclusive intervention rights and collective control over the corporate voting franchise. Together, these represent the two key legal dimensions of the shareholder primacy 'doctrine' (as such) in the sense defined above.

a. Shareholders as the Ultimate Beneficiary of the Director's Duty of Loyalty

Undoubtedly the most overt legal component of the shareholder primacy doctrine in the UK is the director's fiduciary duty of loyalty under company law. In this regard, section 172(1) of the Companies Act 2006 expressly stipulates today that, in exercising his official managerial and/or control functions, '[a] director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members [i.e. ordinary shareholders] as a whole'.

The section further provides that, in determining which specific course of action in any instance is most conducive to promoting the success of the company for the benefit of its shareholders, a director should have regard to a non-exhaustive list of additional 'stakeholder' criteria including, inter alia, 'the interests of the company's employees'.[1] However, the wording of the provision makes it equally clear that directors' mandated

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[1] The other additional 'stakeholder' criteria explicitly referred to in s. 172(1) are 'the likely consequences of any decision in the long term'; 'the need to foster the company's business relationships with suppliers, customers and others'; 'the impact of the company's operations on the community and the environment';

consideration of employee interests is not an independent corporate objective in itself, but rather merely a procedural means towards the ultimate end of enhancing business success and consequent shareholder wealth.

That is to say, a board is expected to give due regard in its strategic deliberations to the risk that neglect of worker (or, indeed, any relevant stakeholder) welfare factors in a given scenario could have a potentially negative impact on long-run shareholder wealth. Such risk factors could potentially include the danger of proposed employee layoffs eroding valuable and irreplaceable firm-specific human capital; or the possibility of a suggested corporate downsizing or restructuring initiative reducing the perceived security and trust of the firm's continuing workforce, thereby undermining employees' general morale and productivity, and also their future incentives to develop non-readily-redeployable skills or attributes. Insofar as both these outcomes entail correspondingly adverse implications for corporate financial performance, they ultimately pose a threat to shareholder welfare and – to this extent (but no more) – thus become relevant and legitimate fiduciary concerns for boards.

As has been widely remarked on by commentators, the likelihood of either the 'shareholder' or 'stakeholder' (including employee) elements of section 172 actually being enforced against directors is, for a variety of reasons, minimal to say the least (Keay 2007a; Keay 2012). However, while this may be a significant concern from an orthodox company lawyer's perspective, from a broader corporate governance standpoint – that is, in terms of calibrating appropriate managerial incentives and disciplines – it is not necessarily so problematic. Indeed, notwithstanding the unlikelihood of enforcement action arising from breach of any of its particular doctrinal components, section 172 undeniably retains considerable 'soft' behavioural influence as a salient and authoritative public statement of the proper corporate objective in the UK.[2] Moreover, this expressive quality of the section is reinforced to the extent that it features in legal-professional advice given to corporate boards, on the permissible scope of their discretion with respect to any particular strategic matter before them (Cerioni et al 2008).

'the desirability of the company maintaining a reputation for high standards of business conduct'; and 'the need to act fairly as between members of the company'.

[2] On the capacity of law to exert an indirect educative effect by making 'statements' as opposed to determining social behaviour directly, see generally Sunstein 1996.

Of course, irrespective of the precise doctrinal substance of the director's duty of loyalty today, company lawyers will readily testify that directors' discretion to determine what is actually conducive to promoting the success of the company for the general benefit of its shareholders is in practice largely unbounded. Although, strictly speaking, there is no explicit US-style business judgment rule applicable in the UK context, English courts have nonetheless tended to adopt a similarly deferential approach to their Delaware counterparts in evaluating subjective strategic decisions taken by directors.[3] Thus while – as explained above – the shareholder-oriented duty of loyalty remains influential to some extent on an expressive or normative level (especially when coupled with supportive managerial incentive mechanisms such as performance-related pay linked to shareholder return) – it is on its own of limited determinative 'bite' as a means of inculcating the shareholder primacy norm into the UK's collective corporate-managerial mindset: that is, at least relative to other, more coercive legal mechanisms in this regard.

b. Shareholders' Exclusive Intervention and Director-Appointment Rights

Notwithstanding the abovementioned practical limitations of the director's duty of loyalty as a corporate governance mechanism, it is noteworthy that under UK company law shareholders additionally enjoy various statutory rights of intervention in corporate decision-making that are not available to other corporate constituencies. These include relatively 'soft' entitlements such as the collective rights to approve or veto board decisions on certain major aspects of corporate policy,[4] and to propose and pass resolutions on specific issues of concern.[5] They also include 'harder' entitlements such as the collective right to dismiss underperforming directors (or even the board as a whole) without cause,[6]

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[3] See, e.g. *Re Smith & Fawcett Ltd* [1942] Ch 304; *Regentcrest plc v Cohen* [2001] BCC 494. On this generally, see Moore 2013: 144–57.

[4] See, e.g. (in the case of Premium Listed companies) Listing Rules 10 (significant transactions) and 11 (related party transactions); (and, in the case of all UK-registered companies) Companies Act 2006, ss 177, 182 (director's general duties to declare interest in proposed/existing transaction or arrangement) and 190–196 (shareholders' approval of substantial property transactions).

[5] Companies Act 2006, ss 314–316 and 338–340.

[6] Ibid., s. 168.

and to alter the company's basic constitutional division of power between shareholders and directors in favour of the former constituency.[7]

Underpinning these formal powers in the case of public companies, moreover, is shareholders' important collective entitlement to exercise the final say over the outcome of a contested takeover bid, by virtue of the so-called 'board neutrality' rule in the UK Takeover Code.[8] Accordingly, British public company boards (unlike their US counterparts) are prohibited from deploying so-called 'poison pills' and other coercive anti-takeover measures, where their effect is to preclude a target company's shareholders from being able to consider the merits of a bid. This in effect makes shareholders the ultimate arbiter of the board's fortunes, given that a successful hostile takeover – once implemented – will almost certainly result in the wholesale disposition of a target company's incumbent management team (Easterbrook and Fischel 1981; Bebchuk 2002).

From a corporate governance point of view, shareholders' statutory intervention rights in the above respects would appear to be more directly influential than the director's duty of loyalty in compelling ongoing managerial promotion of shareholders' interests, particularly as these rights can potentially be employed by shareholders in a more proactive way than directors' duties. That is to say, whereas enforcement of directors' duties (including the duty of loyalty) is typically a (limited) way of redressing losses which have already been incurred, enforcement of shareholders' intervention rights – by contrast – can enable perceived governance or business performance issues to be resolved before they occasion further costs to the firm.

Shareholders' statutory intervention rights are thus an important component of the UK's corporate governance legal framework. However, they are not in themselves fundamentally determinative of shareholders' relative governance primacy vis-à-vis employees. Indeed, the fact that many of the above rights are unavailable to shareholders of US corporations – or, in some instances, available only in a much more limited or conditional way – is remarkable given that, on the whole, shareholders' interests do not appear to be any less central to the operating objectives of US public corporations than in the case of their UK counterparts (Keay 2007b). The ensuing implication is that, in terms of constituting the collective governance influence of shareholders as a corporate

[7] Ibid., s. 21.

[8] The Takeover Code (May 2013), General Principle 3 and Rule 21, at www.thetakeoverpanel.org.uk/wp-content/uploads/2008/11/code.pdf.

constituency in the UK, shareholders' intervention rights – while by no means immaterial – are evidently not the principal legal driver.

It can indeed be surmised that, irrespective of how extensive (or limited) shareholders' particular statutory entitlements in this regard are, as a constituency shareholders will still be in a relatively favourable position when it comes to having their collective interests taken into account by management. This is by virtue of a much more general and fundamental legal benefit that shareholders customarily enjoy within UK (and, likewise US) corporate governance, which can be said to represent the structural basis of the shareholder primacy doctrine. That privilege is *shareholder exclusivity over the corporate voting franchise*, which ultimately underpins – on a basic level – the various more specific decision-making rights of shareholders referred to above. Accordingly, a company's directors are customarily elected by – and hence owe their continuing right to hold office to – that firm's body of ordinary shareholders alone. It would appear that this particular feature of the UK's corporate governance legal framework represents the root source of shareholders' formally privileged status within the firm.

Somewhat curiously given its systemic importance, exclusive shareholder enfranchisement is not, strictly speaking, a mandatory requirement for UK companies. Under the default Model Articles of Association applicable to UK companies, shareholders are formally empowered (concurrently with the board itself) to appoint new directors by way of ordinary resolution,[9] where necessary by proposing a shareholder resolution[10] or even convening a General Meeting specifically for this purpose[11] in accordance with the applicable statutory procedures. Like any provision of a company's articles this basic rule is formally subject to variation by individual firms. However, in the case of Premium-Listed companies it is reinforced by the express UK Corporate Governance Code requirement – applicable on a 'comply or explain' basis – that directors be (re-)elected *by shareholders*, which in larger FTSE 350 firms at least should take place on an annual basis.[12]

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[9] See the Companies (Model Articles) Regulations 2008, Sch. 1 ('Model Articles for Private Companies Limited by Shares'), art. 17(1); Sch. 3 ('Model Articles for Public Companies'), art. 20.

[10] Companies Act 2006, ss 338–339.

[11] Ibid., ss 303–304.

[12] See Financial Reporting Council, *UK Corporate Governance Code* (April 2016), Code Provision B.7.1, at www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Corporate-Governance-Code-April-2016.pdf.

Notwithstanding its formally non-binding status, the principle of shareholder exclusivity with respect to director appointments is a highly prevalent UK corporate governance norm. Its principal functional consequence is that UK corporate boards – while formally separate decision-making organs vested with their own autonomous executive powers[13] – are nonetheless ultimately representative of *shareholders alone*, and, correspondingly, are in no part whatsoever directly accountable to employees or indeed any other corporate constituency.

3 THE HISTORIC AMBIGUITY AND INSTABILITY OF THE SHAREHOLDER PRIMACY POSITION IN UK COMPANY LAW

a. The Historic Ambiguity of the Corporate Objective under Directors' Fiduciary Law

From a historical standpoint section 172's express statutory statement of the British corporate objective – affirming the lexical primacy of the interests of shareholders over those of (inter alia) employees – has in general been regarded as a relatively trivial legal innovation. Indeed, the common view of both the government-appointed steering group that initially formulated the relevant provision, and those courts which have subsequently been called upon to interpret it,[14] is that section 172 constitutes merely a codified version of the pre-existing legal position in this regard, rather than any sort of meaningful substantive reform in itself (CLRSG 2000). Moreover, this assumption would even seem to be implicit in the wording of the Companies Act 2006 itself, section 170(4) of which states that '[t]he general duties [of directors] shall be interpreted and applied in the same way as common law rules or equitable

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[13] See the Companies (Model Articles) Regulations 2008 (SI 2008/3329), Sch. 1 ('Model Articles for Private Companies Limited by Shares'), art. 3; Sch. 3 ('Model Articles for Public Companies'), art. 3; both of which expressly provide that '[s]ubject to the articles, the directors are responsible for the management of the company's business, for which purpose they may exercise all the powers of the company'. On this, see also *Automatic Self-Cleansing Filter Syndicate Co v Cunninghame* [1906] 2 Ch 34; *John Shaw & Sons Ltd v Shaw* [1935] 2 KB 113; Moore and Reberioux 2011: 95–99.

[14] See, e.g. *Re Southern Counties Fresh Foods Ltd* [2008] EWHC 2810; *Re West Coast Capital (Lios) Ltd* [2008] CSOH 72.

principles, and regard shall be had to the corresponding common law rules and equitable principles in interpreting and applying the general duties'.

Insofar as the former (i.e. pre-2006) position of non-shareholder constituencies *other than* employees is concerned, the above view is arguably correct, insofar as consideration for the welfare of a company's various non-shareholder constituencies – at least within reasonable bounds – has always been recognised as an implicit component of responsible business management notwithstanding the shareholder primacy doctrine.[15] However, with respect to the relative governance status of shareholders *and employees* in the UK, the pre-2006 legal position was somewhat different.

Contrary to the above assertions, section 172's immediate predecessor, namely section 309 of the former Companies Act 1985, was not a direct functional analogue of the current provision. For a start, old section 309 – introduced, somewhat curiously, by Margaret Thatcher's Conservative administration shortly after coming to power in 1979 (Durham 1982)[16] – made reference only to employees, and did not expressly deal with other non-shareholder constituencies (although, as explained above, a reasonable degree of instrumental directorial concern for such interests was tacitly acceptable under the common law). Moreover, section 309's basic doctrinal character was notably different to that of section 172, with the former rule providing that 'the matters to which the directors of a company are to have regard in the performance of their functions include the interests of the company's employees in general, as well as the interests of its [ordinary shareholders]'.[17]

Thus, unlike in the case of section 172 today, no explicit lexical priority was afforded to the interests of shareholders over employees under section 309 (Parkinson 1993).[18] Accordingly, the notional 'interest of the company' which directors were expected to promote was in effect rendered an amalgam of the respective interests of shareholders and employees, with neither constituency apparently enjoying systematic fiduciary precedence over the other.[19] Admittedly, the absence in section 309 of any direct enforcement right for employees led to accusations of it being something of a 'toothless tiger' from labour's perspective, causing

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[15] See, e.g. *Evans v Brunner Mond* [1921] 1 Ch 359; *Simmonds v Heffer* [1983] BCLC 298.

[16] See Companies Act 1980, s. 46.

[17] Companies Act 1985, s. 309(1).

[18] See *Re Welfab Engineers Ltd* [1990] BCLC 833.

[19] See *Fulham Football Club Ltd v Cabra Estates* [1992] BCC 863.

one commentator in particular to describe the provision as 'either one of the most incompetent or one of the most cynical pieces of drafting on record' (Sealy 1987: 177). Notwithstanding this obvious limitation, though, old section 309 at the very least offered an effective doctrinal 'shield' to directors who gave extensive consideration to employee concerns, against potential allegations of breach of duty on account of neglecting the competing interests of shareholders (Parkinson 1993). This is not to mention the additional normative significance of the pre-2006 provision in formally enshrining employee welfare considerations as an explicit and central element of boards' expected fiduciary remit (Wedderburn 2004).

Against this background, it becomes apparent that section 172 – in spite of its purported intent to 'enlighten' directors as to the economic materiality of non-shareholder considerations – in effect brought about the lexical *relegation* of employees within UK corporate governance on a formal and normative level. In particular, employees' interests were notionally downgraded relative to those of shareholders, in that consideration of worker welfare factors was recognised by section 172 merely as a secondary means to the ultimate end of shareholder wealth maximisation. In comparison to the pre-2006 position, section 172 could also be said to have relegated employees' governance status in relation to other non-shareholder constituencies such as suppliers, customers, the community and the environment, whose interests are now formally ranked on a par with those of employees, thus depriving employees of any claim to relative governance primacy over those groups (Wedderburn 2004).

Of course, old section 309 was in itself a fairly recent development. Its introduction in 1980 was a legislative response to longstanding concerns about the under-representation of employees' interests within UK company law. Indeed, *prima facie* at least, it would appear that English courts have historically tended to recognise shareholders as the exclusive collective beneficiary of the director's duty of loyalty (Parkinson 1993). This is with the limited exception of 'red zone' scenarios where the company's solvency is under threat, in which event creditors assume the status of the firm's principal residual risk-bearer and – correspondingly – become the principal focus of directors' fiduciary responsibilities (Keay 2002).

Curiously, though, the main cases which are customarily cited in support of the traditional shareholder orientation of the director's duty of loyalty at common law are, on closer inspection, of somewhat questionable authority in this regard. The principal decision which commentators have tended to advance as authority for the shareholder primacy position in UK company law is the Court of Appeal's ruling in the 1951 case of

Greenhalgh v Arderne Cinemas Ltd.[20] In this case, Evershed MR advanced the oft-cited proposition that the notion of 'the benefit of the company as a whole' – bona fide pursuit of which is customarily regarded as a director's proper fiduciary objective – should not be understood in terms of the autonomous interest of 'the company' in itself as a commercial entity, but rather as denoting nothing more than the aggregate personal interests of the shareholders 'as a general body' (in the contractarian sense).[21]

As one leading commentator has observed, 'this quotation from the ruling is cited almost invariably as evidence that company law requires companies to have a profit maximising objective, and that managers and directors have a legal duty to put shareholders' interests above all others and no legal authority to serve any other interests' (Attenborough 2009: 343). However, as the same commentator points out, those who seek to rely on the *Greenhalgh* decision as authority for the shareholder primacy position typically elide the fact that Evershed MR's comments in this case were expressly limited to 'such a case as the present',[22] as opposed to laying down any sort of generally-applicable normative proposition.

Moreover, as Attenborough (2009) further highlights, the 1951 *Greenhalgh* case itself was concerned not with construction of the proper corporate objective in a directors' duties context, but rather with the very different factual (and, indeed, legal) setting of a majority v minority shareholder dispute concerning alteration of a company's articles of association. Accordingly, Evershed MR's reference to 'the benefit of the company as a whole' in *Greenhalgh* would appear to pertain specifically to the judicial test for establishing the (in)equity of a proposed constitutional alteration in a private company context, where a focus on the personal interests of shareholders was not only appropriate but indeed practically necessary. However, such a scenario bears no direct relevance to the question of the propriety of the shareholder wealth maximisation objective in the case of publicly traded corporations. Contrarily, Attenborough (2009: 346) asserts (in relation to the pre-2006 position at least) that '[a]s a positive matter, UK company law does not and never has imposed a legal obligation on directors to maximise shareholder value.'

Furthermore, it would seem that other classic English decisions which have been interpreted as affirming shareholders (over employees) as the

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20 [1951] Ch 286.
21 Ibid., 291.
22 Ibid.

rightful beneficiary of directors' fiduciary discretion actually have similarly limited direct bearing on this issue. For instance, the Court of Appeal's decision in the 1883 case of *Hutton v West Cork Railway Company*[23] – and, in particular, Bowen LJ's classic dictum that 'there are to be no cakes and ale [for employees] except such as are required for the benefit of the company'[24] – has subsequently been construed as authority for the principle that worker welfare may only be enhanced by directors where this is instrumental to long-term benefits for shareholders.[25] Likewise, Plowman J's refusal in the 1962 case of *Parke v Daily News Ltd*[26] to permit directors to distribute the proceeds from sale of a company's newspaper business gratuitously to certain employees has been widely construed as a pro-shareholder-primacy decision (Sealy and Worthington 2013), in a similar vein to the classic judicial principle established in *Dodge v Ford Motor Company*,[27] a US case from 1919 based on not-dissimilar facts. In the latter case, the Michigan Supreme Court had held that:

> A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end and does not extend to a change in the end itself, to the reduction of profits or to the nondistribution of profits among stockholders in order to devote them to other purposes.

But while the above dictum may provide a reasonably accurate portrayal of the traditional US approach[28] to determining the fiduciary propriety of

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[23] (1883) 23 Ch 654.

[24] Ibid., 673.

[25] For example, in their highly authoritative UK company law treatise, Sealy and Worthington (2013: 320, emphasis added) claim that, 'in cases like *Hutton v West Cork Rly Co* and *Parke v Daily News Ltd*, generosity to employees was held to be lawful only if it could be justified by reference to the long-term interests of *the shareholders*'.

[26] [1962] Ch 927.

[27] 170 NW 668 (1919).

[28] Although *Dodge v Ford* is a Michigan authority and thus, under the United States' federalist system of corporate law, formally inapplicable outside of this specific jurisidictional setting, it has generally been recognised throughout the past century as a valid authority by numerous other US States' courts including, inter alia, the dominant corporate law jurisdiction of Delaware. For this reason, we believe that it can, with considerable justification, be described in broad terms as a general 'US law' position as such. For a (somewhat qualified) recent reaffirmation of the basic *Dodge v Ford* position in a Delaware context, see

directors' decisions concerning employee welfare considerations, as a statement of the corresponding *English* position in this regard (at least prior to 2006) it is highly contestable.

It is noteworthy that the *Hutton* ('cakes and ale') case – unlike the *Dodge* case in the US – involved the relatively peculiar incidence of a company purporting to make gratuitous payments to its outgoing directors immediately prior to the company's winding up, using funds which would otherwise have been distributable to creditors. Accordingly, the board's conduct in this case – which, curiously, was formally approved by a majority of its shareholders – entailed not just a manifest (albeit authorised) conflict of interest on the relevant directors' part, but was also at least equally detrimental to the welfare of future creditors as it was to immediate shareholder wealth,[29] involving a scenario which today would likely be dealt with (inter alia) under relevant aspects of insolvency legislation.

Moreover, contrary to accepted wisdom, the respective rulings in *Hutton* and also the later *Parke* case manifestly hinged not on the (assumed) general fiduciary ground that the relevant boards favoured employees' interests over shareholders' interests. Rather, they were decided on the specific doctrinal premise that – in both instances – corporate funds were expended for a purpose which was not reasonably incidental to the relevant company's particular business objects as set out in its memorandum of association.[30] Accordingly, the payments in question were invalidated on relatively technical *ultra vires* grounds, in fundamentally the same way that the diversion of business funds to shareholders (e.g. as dividends) at a time when the company has no distributable profits would have been struck down for being outside the

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Chancellor Chandler's ruling in the 2010 case of *eBay Domestic Holdings, Inc. v Newmark* 16 A. 3d. 1 (Del. Ch. 2010). For a critical perspective on the doctrinal and normative sustainability of the *Dodge v Ford* decision, see Stout 2008.

[29] On the relevance of concern for future creditor interests to the court's determination in *Hutton*, see the opinion of Bowen LJ, supra n 23, 675–6.

[30] As explained by Bowen LJ in *Hutton*, ibid., 672:

> The money which is going to be spent is not the money of the majority. That is clear. It is the money of the company, and the majority want to spend it. What would be the natural limit of their power to do so? They can only spend money which is not theirs but the company's, if they are spending it for the purposes which are reasonably incidental to the carrying on of the business of the company. That is the general doctrine..

company's ordinary course of business.[31] Thus in both cases, the relevant court was unwilling to sanction the proposed payment because it was not conducive to furthering the interests of *the business* according to the company's pre-articulated objects, such that – in contrast to the position in *Dodge* – the issue of shareholder primacy *per se* never directly entered the picture.

The prescriptive implication is that, under the pre-2006 *Hutton/Parke* principle, corporate funds could legitimately be devoted to shareholders and/or employees as the directors reasonably deemed fit for the furtherance of the company's constitutionally specified line(s) of business, so long as the interests of *the business* as such were genuinely being promoted in some way. Curiously, this position would appear to be more consistent with the bipartisan 'balancing' logic of section 309 than with the 'lexical' rationality of section 172 and *Dodge*, an observation which is reinforced by noteworthy modern judicial dictum to the effect that '[t]he duties owed by the directors are to the company and the company is *more than* just the sum total of its members'.[32] It thus further supports the view that shareholder (relative to employee) supremacy was never an established element of UK company law prior to the 2006 Act, at least with respect to questions concerning judicial determination of the proper corporate objective.

Consequently, it would appear that section 172 – in expressly affirming shareholders' lexical supremacy over employees in this context – has in effect downgraded employees' formal corporate governance status not just relative to the pre-2006 statutory rule in this regard, but also in comparison to the traditional common law position concerning the relative materiality of shareholder and employee interests in determining what constitutes the notional 'benefit of the company as a whole'. The latter point is particularly significant given the 2006 Act's express provision that pre-existing case law on directors' duties remains valid as an authoritative guide to the interpretation and application of the general statutory duties (including section 172) today.[33] This seems – *erroneously* – to presuppose the functional equivalence of the pre- and post-2006

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[31] Indeed, according to Bowen LJ (ibid):

> The test … is not whether [the payment in question] is bona fide, but whether, as well as being done bona fide, it is done within the ordinary scope of the company's business, and whether it is reasonably incidental to the carrying on of the company's business for the company's benefit.

[32] *Fulham Football Club v Cabra Estates*, supra n 19, *per* Neill LJ, 393, subsequently discussed in Attenborough 2009; Keay 2006.

[33] See Companies Act 2006, s. 170(4), discussed above.

positions, an issue which could potentially pose difficulties for any future court that is called upon to adjudicate on a section 172 dispute concerning directors' alleged disregard (or, vice versa, *over*-regard) of employees' interests vis-à-vis those of shareholders.

b. Bullock, the *Societas Europaea* and the Curious Persistence of Shareholder Exclusivity over the Corporate Voting Franchise

From a comparative European perspective the UK is very much a relative outlier in – remarkably – making *no* formal provision whatsoever for employee representation on corporate boards within its national legal framework.[34] At present, the domestic legal systems of 19 other European countries[35] provide a formal statutory framework for the involvement of employee representatives in high-level corporate decision-making at board level, via a practice known as 'co-determination'.

Interestingly, the notion of employee representation on corporate boards – known in British industrial relations parlance as 'industrial democracy' – has by no means been absent from Labour Party policy agendas in the past, and has also featured prominently in overlapping academic debates. Indeed, in the mid-to-late 1970s the imminent introduction of industrial democracy in the UK appeared to be a foregone conclusion, particularly following the publication of the 1977 Bullock Report on Industrial Democracy commissioned by James Callaghan's Labour administration. In essence, the majority of the committee behind the Report recommended a so-called '2x + y' formula for achieving parity board composition in large companies as between shareholder and employee representatives. This scheme entailed equal numbers of shareholder and employee representatives on the boards of all companies employing more than 2,000 people, subject to a minimum of four

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[34] The minority group of European countries which make no formal legal provision for worker involvement in corporate decision-making are Belgium, Bulgaria, Cyprus, Estonia, Iceland, Italy, Latvia, Liechtenstein, Lithuania, Malta, Romania and Switzerland. See Conchon 2013.

[35] This majority group of European countries which have a so-called 'co-determination' framework in place to some extent or other includes Austria, Croatia, the Czech Republic, Germany, Denmark, Finland, France, Greece, Hungary, Ireland, Luxembourg, the Netherlands, Norway, Poland, Portugal, Sweden, Slovenia, Slovakia and Spain. However, in five of those countries (namely Greece, Ireland, Portugal, Poland and Spain) such procedures are restricted mainly to state-owned or privatised enterprises.

directors on each side. These two constituencies would then be supplemented by a third group of formally neutral co-opted directors, comprising an odd number of at least three so as to prevent potential deadlock. While the Bullock scheme did not envisage co-determination as being a universal requirement for all companies above the relevant size threshold, it did nonetheless recommend that co-determined boards be compulsory where formally requested by a recognised trade union and subsequently approved by a majority of a company's employees (Bullock 1977).

The esteemed company and labour lawyer Paul Davies, one of the most noted academic advocates of employee board representation at the time, explained the rationale behind industrial democracy in terms which still bear strong relevance within today's British industrial relations climate. Writing in 1975, Davies (1975: 254) claimed that '[i]n recent years the British economy has been subject to powerful and continuing pressure for "rationalisation" of productive activities', with the outcome 'that it is no longer sufficient [for employees] to be able to respond to the employment consequences of decisions already taken'. Rather, argued Davies;

> it is necessary for unions and workers to be in a position to exercise control over the primary decisions whether to rationalise and by which methods, … not only as a defensive reaction to adverse economic trends but also as part of a more positive programme aimed at securing for employees greater control over their working environment.

On the other hand, there was a conflicting body of opinion within the labour movement, which regarded the involvement of employee representatives in board decision-making as being both an unnecessary and, moreover, *inappropriate* structural channel for the exercise of collective worker voice within the firm. This alternative school of thought, exemplified most eloquently by the academic work of the classic labour lawyer Sir Otto Kahn-Freund, stressed the inherent conflict between the respective interests of shareholders and employees.[36] So fundamental was this tension, in Kahn-Freund's view, that it was simply impossible to phrase the 'interests of the company' in such a way as to enable this concept to encapsulate the particular interests of employees in those

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[36] Even Lord Wedderburn of Charlton, one of the most influential and respected advocates of industrial democracy in the UK, had earlier been led to concede that 'the position of [employee] directors would not be easy' insofar as they would find themselves 'either excluded from the real discussion of policy, as has been alleged to happen in Germany, or eventually distrusted by those who elected them'. Wedderburn 1965: 16.

instances (e.g. proposed plant closures or mass layoffs) when the latter constituency is most in need of the protection of company law. Accordingly, while Kahn-Freund was not entirely dismissive of the possibility of employee representatives enjoying direct influence over managerial decisions via co-decision-making rights on the board, he was vigilant in emphasising the necessity of such mechanisms being seen as *an extension of* the independent rights of trade unions to protect employees' interests via adversarial industrial action, as opposed to a means of submersing the particular interests of a company's workforce into the general interest of the notional 'company as a whole' (Kahn-Freund 1977).[37]

Kahn-Freund's adversarial view of industrial relations – and corresponding discomfort with the idea of employee representatives becoming co-responsible for corporate-managerial decisions with shareholder representatives – was by no means idiosyncratic for its time. On the contrary, such sceptical – or, at best, ambivalent – attitudes towards the introduction of co-determination in the UK were shared by a significant proportion of the British labour movement in the 1970s, including a number of influential figures within the Labour Party itself. This hesitancy was reinforced by the common opinion of many twentieth century British socialists that the public interest (including worker welfare considerations) would only be effectively upheld by the outright conversion of key private enterprises into government-owned public entities via nationalisation: a vision that had already been realised within many public utilities and heavy industries in the UK during the post-war era. This was seen as preferable to the alternative option of effecting fundamental structural change to the private sector company itself, thereby stinting the potential for meaningful pro-worker reform of established British corporate governance norms (Clift et al 2000).

Consequently, the requisite political will to implement co-determination in Britain was never present, such that the Bullock reform agenda did not make it onto the statute book during Labour's five-year term of government. The coming to power in 1979 of Margaret Thatcher's neo-liberal Conservative administration – whose deep-seated hostility to organised labour is well-known – signalled the effective death knell of the British industrial relations reform movement. Since then, the notion

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[37] In a similar vein, Davies and Wedderburn (1977: 211) argued in 1977 for the introduction of 'novel institutions of conflictual partnership', designed in recognition of the (then-assumed) fact that 'the reality of conflict between workpeople and capital will remain and the powers of workers organised in their trade unions seem likely to increase'.

of industrial democracy in the UK has to a large extent (albeit somewhat unjustifiably) come to be associated with the notoriously confrontational industrial climate of the late-1970s, which reached its low point in the infamous 'winter of discontent' of 1978–9 characterised by seemingly constant strikes, a temporary three-day working week and frequent power blackouts.

Despite 13 years of later Labour rule between 1997 and 2010 under the Blair and Brown administrations, there has been no serious or sustained political impetus in Britain for revisiting the co-determination issue over recent decades, at least on a domestic policy-making level. However, a brief and modest resurgence of the industrial democracy debate occurred at the beginning of the twenty-first century with the UK's implementation in October 2004 of the long-awaited EU Directive on worker involvement in the European Company.[38] This Directive made provision for the involvement of employees in board-level decision-making within any business registered as a *Societas Europaea* (SE) or European Public Limited-Liability Company.[39]

In its original guise in the 1970s,[40] the European Commission's blueprint for worker involvement in the European Company was, from a British perspective, radical to say the least. In essence, the Commission proposed a mandatory framework of employee representation at board level effective within SEs across the EU (then the European Economic Community) as a whole, based loosely on Germany's two-tier board model and featuring parity representation of shareholders and employees on an 'upper' supervisory board in accordance with a Bullock-esque '2x + y' formula. This was to be supplemented by a mandatory system of employee consultation via plant-level works councils (likewise along German lines), with the latter bodies enjoying important co-decision-making rights in determining with management the content of so-called 'social plans' consequent upon economic restructurings (Davies 2003). Moreover, the supplementary Draft Fifth Company Law Directive, introduced in 1972, provided for the mandatory extension of employee board representation and two-tier board structures to *all* public companies incorporated throughout the EU (Dine and Du Plessis 1997).

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[38] See Council Directive 2001/86/EC supplementing the Statute for a European company with regard to the involvement of workers. This Directive was implemented in the UK by the European Public Limited-Liability Company Regulations 2004 (SI 2004/2326) ('the UK Regulations').

[39] See Council Regulation 2157/2001/EC on the Statute for a European company (SE).

[40] See OJ [1970] C124/1, EC Bull. Supp. 8/1970.

It would be an understatement to say that the employee representation requirements as set out in the final draft of the EU worker involvement Directive, published in 2001, were somewhat less stringent in nature (Barnard and Deakin 2002). Above all there was a fundamental change in the policy impetus of the scheme, from its lofty initial ambition of seeking to mandate co-determination within SEs across the EU as a whole (Wedderburn 2004), to the considerably more modest dual goal of: first, affording incorporators a wide ambit of flexibility in designing their own provisions for worker involvement within SEs in line with prevailing national customs;[41] while, second, ensuring that this flexibility is not so wide as to permit incorporators to exploit the SE framework in order to evade any more onerous employee participation requirements applicable in a founder company's 'host' Member State.[42]

Without going into further detail, it is consequently clear that an SE registered in the UK will not be required to adopt any German-style employee participation structure merely by virtue of carrying on its business in the form of an SE, except in those instances where: (i) the SE in question is formed as part of a joint venture between a British company and one or more companies registered in other EU Member States; and (ii) the latter company or companies is/are already subject to mandatory employee participation requirements in place within their own domestic laws (as in the case, for example, of a German or Dutch company).[43] It can reasonably be surmised that such cases will be

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[41] In what would appear to be a stark U-turn on the European Commission's initial position on the matter, recital (5) to the 2001 Directive states that '[t]he great diversity of rules and practices existing in the Member States as regards the manner in which employees' representatives are involved in decision-making within companies makes it inadvisable to set up a single European model of employee involvement applicable to the SE'. Accordingly, both the Directive and the implementing UK Regulations make provision for the reaching of private agreement between management and employee representatives on the appropriate arrangements (if any) for employee representation on the board, with the standard legislative requirements in this regard operating on a default basis only. See *supra* n 38.

[42] In this regard, recital (3) to the 2001 Directive (ibid) explains that, '[i]n order to promote the social objectives of the [EU], special provisions have to be set … aimed at ensuring that the establishment of an SE does not entail the disappearance or reduction of practices of employee involvement existing within the companies participating in the establishment of an SE'.

[43] The domestic rules for employee board participation in UK-registered SEs require that:

extremely rare, an assumption which would appear to have been borne out by practice so far.

Coupled with the extremely low incidence of SE incorporations in the UK to date in general (Hannigan 2016), the above factors suggest that, all things considered, the EU Directive on worker involvement in the European Company is of negligible impact insofar as established British industrial relations practices are concerned. Meanwhile, the potentially more far-reaching proposals for employee participation set out in the abovementioned Draft Fifth Company Law Directive have never been implemented (Dine and Du Plessis 1997), and the latter Directive itself has since been abandoned (Davies 2015). While the supplementary EU legislative framework on information and consultation of employees ('ICE')[44] in theory provides an additional degree of worker influence over corporate decision-making – particularly in the case of undertakings established *other than* by way of an SE – such influence is significantly limited in practice (Ewing and Truter 2005). The relevant ICE requirements are applicable only conditionally upon the formal request of a sizeable number or percentage of employees of the relevant undertaking.[45] Furthermore, by nature they provide employees only with the

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> where the employees or their representatives of at least one of the participating companies had participation rights, the representative body shall have the right to elect, appoint, recommend or oppose the appointment of a number of members of the administrative or supervisory body of the SE, such number … be[ing] equal to the highest proportion in force in the participating companies concerned before the registration of the SE.

See the UK Regulations, supra n 38, Sch. 3, para. 7(2).

[44] See Directive 2002/14/EC of the European Parliament and of the Council establishing a general framework for informing and consulting employees in the European Community, as implemented in the UK by the Information and Consultation of Employees Regulations 2004 (SI 2004/3426); and Council Directive 94/45/EC on the establishment of a European Works Council or a procedure in Community-scale undertakings and Community-scale groups undertakings for the purposes of informing and consulting employees, as implemented in the UK by the Transnational Information and Consultation of Employees Regulations 1999 (SI 1999/3323).

[45] Where a formal employee request is made to negotiate an agreement in respect of information and consultation under the 2004 Regulations (ibid), reg. 7(2) thereof provides that such a request is only valid if made by at least 10% of the employees of the undertaking in writing. If, on the other hand, an employee request is made to negotiate an agreement for a European Works Council or alternative information and consultation procedure under the 1999 Regulations (ibid), reg. 9 thereof requires that a written request be made by a minimum of

relatively 'soft' entitlement to be informed of and consulted on managerial initiatives affecting their interests, as opposed to vesting employees with any sort of 'hard' decision-making power share in the form of partial board representation or otherwise.[46]

In any event, the continuing applicability of the European Company and ICE frameworks as a whole within the UK is now seriously in question following the country's recent 'Brexit' vote, which provides further reason to discount the practical relevance of those schemes to domestic corporate governance and industrial relations norms today.

4 IS THE UK'S SHAREHOLDER-CENTRIC COMPANY LAW REGIME SUSTAINABLE?

The introduction to this chapter remarked on the apparent curiosity of the fact that employees are typically afforded so little direct corporate governance influence under UK company law, at least in relation to the corresponding degree of influence afforded to shareholders. Indeed, shareholders' formal governance primacy over labour is remarkable on a number of levels. From an economic point of view, it is at least debatable whether the functional value to British companies of shareholders' risk capital is sufficiently high relative to that of employees' human capital to merit a national corporate governance paradigm dedicated exclusively to furtherance of the former constituency's interests. From a political standpoint, meanwhile, it is a matter of note that the interests of workers have not featured more emphatically in domestic corporate governance regulatory and policy initiatives in the UK, particularly given the significant influence of labour as a general political constituency for much of the twentieth century.

But while – historically – employees have not garnered much direct consideration in the specific realm of UK company law, as a corporate

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either 100 employees (whether personally or representatively) in at least two undertakings or establishments in at least two different EU Member States.

[46] In this regard, the official UK government guidance on the 2004 Regulations (ibid) makes clear that 'employers are not obliged to follow the [employee] representatives' opinion', and therefore that '[d]ecision-making remains the responsibility of management'. See DTI 2005: 45. In a similar vein, reg. 8 of the 1999 Regulations (ibid) provides that, although employee works councils shall have the right to meet with management to discuss particularly pertinent labour-related issues such as relocations, closure of establishments and collective redundancies, any opinions or suggestions put forward by the works council in those respects 'shall not affect the prerogatives of central management'.

constituency they have undoubtedly been empowered in other important respects over the past century. It was explained above how a key factor underlying the British labour movement's traditional unease with German-style employee board representation has been its longstanding general view that workers' interests are more effectively protected *outside of* the corporate governance process itself. Accordingly, labour has tended to exercise its collective 'voice' as such within (or, strictly speaking, *outside*) the firm on an indirect and fundamentally *non*-cooperative basis, by means of the trade-union-initiated practice of 'arm's length' collective bargaining with management on general terms and conditions of employment. Indeed, it was largely for this reason that – as recounted above – employee board representation was widely regarded (even by many vociferous supporters of worker empowerment) as an inappropriate and superfluous legal innovation, which was inherently out of sync with the basic adversarial dynamic of the British industrial relations system.

However, times have undoubtedly changed in the UK over the past four decades, with the consequence that today's national industrial relations climate bears very little resemblance to the context in which Bullock's landmark co-determination blueprint for Britain was considered (and ultimately dismissed) back in 1977–78. In the intervening period the overall level of trade union membership in the UK has fallen by approximately 50 per cent, from a peak of 12.2 million citizens in 1980 to just 6.4 million today (as of 2014), such that less than 10 per cent of the UK population is now unionised (Dept BIS 2015). Over the same period, the percentage of the UK workforce covered by collective agreements on working terms and conditions between unions and employers (so-called 'collective bargaining density') has fallen from 82 per cent to approximately 20 per cent (Ewing 2015). On a public policy level, meanwhile, recent years have witnessed the continuing decentralisation and dismantling of collective bargaining structures across the UK and Europe more generally (Ewing 2015), including – in the form of the Trade Union Act 2016 – controversial domestic legislation aimed at heightening the legal barriers faced by unions in seeking to initiate strikes and other coercive forms of industrial action vis-à-vis employers.

Moreover, these developments have occurred within a general labour market climate characterised by increasingly 'flexible' or 'insecure' (depending on one's particular perspective) working patterns including zero-hours contracts, agency work and independent contracting. Perhaps unsurprisingly in light of these factors, the British trade union movement has long abandoned its traditional antipathy to worker involvement in corporate decision-making at board level, and indeed has recently expressed support for exploring potential reform options in this regard

(Conchon 2013). Notwithstanding the current UK Prime Minister's recent rhetorical posturing on this issue, though, it is fair to say that the chances of co-determination becoming a general feature of the British corporate governance and industrial relations landscape today seem remote, at least as things presently stand.

Whether Britain's existing shareholder-centric company law framework is sustainable *in the long run*, though, is an altogether different matter. Certainly, there is significant cause to question whether UK company law's pivotal principle of shareholder primacy remains a relevant and legitimate position today from the standpoint of British society at large. Unlike in the US where the notion of the 'shareholder-citizen' has fairly widespread cultural resonance amongst the general (or at least middle-class) public (Gelter 2013; Tucker 2012; Davis et al 2006), the UK would appear to have no comparable socio-political tradition of popular shareholder consciousness.

Additionally, whereas in the UK (as in the US) private pension wealth – generated in large part from returns on corporate equity holdings – constitutes the largest component of aggregate household wealth today (ONS 2014; Gottschalck et al 2012), it is noteworthy that private pension wealth *only* outstrips other sources of wealth for the top two deciles of the British population as determined by wealth: that is, for those citizens with total household wealth of £1,754,787 and above (ONS 2014; ONS 2015). For the great majority of UK citizens falling below this wealth threshold, pension wealth – and thus, by implication, shareholder return – actually constitutes a small and relatively insignificant component of total household wealth today, at least relative to other wealth sources such as employment income and home equity. Accordingly, despite successive policy initiatives in recent decades aimed at instilling a greater collective sense of shareholder consciousness among the British public, the contemporary evidence would suggest that relatively few working UK citizens actually have cause to identify themselves as 'shareholders' (in preference to 'workers') in any meaningful material sense.

Moreover, with seemingly increasing levels of financial disenfranchisement among Britain's younger working generations today including the reduced availability and/or reliability of traditional occupational pension schemes, it may reasonably be queried whether we are witnessing the consequent *destruction* of the latent social contract on which the legitimacy – and, in turn, long-term sustainability – of the UK's shareholder-oriented corporate governance model has traditionally been predicated. Further consideration of this issue lies outside the scope of the present chapter. For immediate purposes, though, it suffices to say that – if this is indeed the case – then one can envisage concentrated popular support for

the implementation of *pro-worker* corporate governance policies arising within the not-too-distant future. This could, in turn, potentially encourage a serious and sustained revisiting by policy-makers of the long-dormant debate on the merits of industrial democracy in the UK. Indeed, it is not inconceivable that the recent murmurings of co-determination within the British political arena may well represent the fledgling beginnings of such a development.

5 CONCLUSION

As a subject of comparative company law and corporate governance analysis, the UK represents a somewhat difficult jurisdictional case study. *Prima facie*, the country's predominantly shareholder-oriented company law framework would appear consistent with the general neo-liberal disposition of its political economy over recent decades. However, this rather crude characterisation of the British political compass is only of relatively recent relevance, and in any event fails to accommodate the significant social-democratic elements of the UK's unique model of welfarist market capitalism.

Moreover, as the above discussion has additionally highlighted, even the commonly accepted depiction of British company law as being a shareholder-centric phenomenon is itself subject to a degree of question, once the significant historic ambiguities and contentions to this position are considered. These latent factors demonstrate that, while the predominant shareholder orientation of the UK's company law framework *today* would seem to be clear and uncontested, such contemporary doctrinal and normative cohesiveness actually serves to mask a longer history of considerable uncertainty and/or turmoil in those respects.

An important implication of the above findings is that any attempt to correlate the UK's prevailing (shareholder-oriented) company law regime to its corresponding economic and/or socio-political context is necessarily descriptively problematic, given that the messy and haphazard development of both would appear to defy any logical functional or normative characterisation. Looking ahead, meanwhile, it can be surmised that the continuing legitimacy – and, by implication, long-term sustainability – of the shareholder primacy doctrine in the UK is, like that of any socially significant legal institution, ultimately contingent on its continuing implicit acceptance by the British public at large. And, as the above discussion has demonstrated, shareholder primacy has always been something of an uneasy normative fit with corresponding currents of socio-political sentiment in modern Britain. Moreover, based on current

demographic trends at least, this problem looks likely to be exacerbated insofar as Britain's younger and future working generations are concerned.

Whether and precisely how British company law will respond to those challenges remains to be seen. For immediate purposes, though, it suffices to say that the foundations of the UK's shareholder-centric company law framework are not quite as firmly and unequivocally established as a cursory reading of the relevant legal provisions might suggest.

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7. German company law 1794–1897

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At the onset of the nineteenth century, German law reflected a heavy French influence. This influence especially extended to commercial-law matters. However, during the nineteenth century, German company law diverged significantly from that in other industrial countries, including France. Some of that divergence reflects a different approach to corporation law, and some reflects the importance of enterprise forms more important in Germany than elsewhere. This chapter traces the development of German company law from the late eighteenth century to the adoption of a new commercial code at the end of the nineteenth century.

Prior to the *Reich*'s foundation in 1871, 'Germany' consisted of two large, contending states and a host of medium- and small-sized political entities gathered under the umbrella of the *Bund*, or federation (1815–66). Each state had, in principle, its own law. The *Bund* was little more than a talking-shop: the legal agreements discussed below were among its only accomplishments. Prussia comprised the largest single German state prior to unification, the core and leader of the North German Confederation 1866–71, and the pivotal state in the unified Germany established in 1871. Habsburg Austria counted as the *Bund*'s other significant power, but plays a smaller role in our story.

Prussia's size and more innovative approach to law made it the leader for the developments we discuss.[1] This chapter frames the discussion for events prior to 1871 by focusing on Prussia, turning to Austria and to other German states to illustrate diversity or contention. Focus on Prussia does not, however, allow us to escape all legal diversity. The 1794 *Allgemeines Landrecht für die Preußischen Staaten* (ALR) combined matters later separated into civil and commercial codes. The ALR never

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1 Prussia accounted for about 62 percent of the population and 64 percent of the area in the 1871 *Reich*.

held sway throughout all of Prussia. Until 1900 and the introduction of the all-German *Bürgerliches Gesetzbuch* (BGB) Prussia's Rhineland province retained French law, the *Code Napoléon* for civil-law matters.[2] In 1861, Prussia, along with nearly all German states, adopted the *Allgemeines Deutsche Handelsgesetzbuch* (ADHGB), creating legal uniformity for commercial law. The North German Confederation and later *Reich* adopted the ADHGB, as well. In 1900 the unified Germany adopted its new civil code (the BGB), and at the same time put into force a new commercial code (the *Handelsgesetzbuch* or HGB) that had been completed in 1897. The HGB influenced but did not apply to Austria, which after the *Bund*'s dissolution in 1866 no longer had constitutional ties to Germany.[3]

To some scholars, 'company law' means the law of corporations. This focus on the corporation is limited today and more limited for the past.[4] Most German governments strictly limited access to the corporate form until 1870. After 1884, legislation intended to protect shareholders and creditors made the corporation less attractive than its counterpart in the U.K, the U.S., and other industrial countries. We thus stress the full range of multi-owner enterprise forms, beginning with the partnership under both the ALR and the *Code de Commerce*.

The presentation is not entirely chronological: a brief sketch of major innovations will help guide the reader through the following. The ALR (1794) and the *Code de Commerce* (1807) provided the legal framework for company law in Prussia until the ADHGB's introduction in 1861. Prussia had earlier provided more structure for corporations in legislation concerning railroads (1838) and then corporations in general (1843). The ADHGB revised the rules for all company forms and put them on a

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[2] Prussia was not alone in having multiple legal systems. The 1815 territorial settlements meant that several German states (including Baden, Württemberg, and Bavaria) acquired territory that hitherto had different law. French law persisted either directly or as a heavy influence in many German states; see Schubert (1977a, 1997b) for French law in Germany under the French and until the 1820s. See also Eisenhardt (2013, pp. 308–12).

[3] Civil codes usually permit the creation of business entities under their own rules. Ordinarily, civil-law businesses are small or intended for some short-term end. This chapter stresses the commercial code.

[4] The corporation does play an outsized role in the U.S. today and in the past. Business and economic historians, for their part, have followed Alfred Chandler's stress on the role of large corporations perhaps a bit too closely (Chandler 1977). In some countries – Germany being an important example – corporations were comparatively uncommon. See Guinnane et al (2007).

common, (nearly) all-German basis. In 1870 the North German Confederation relaxed rules on formation of corporations, leading, under the new *Reich* (1871), to a boom in corporation foundations. Following the deflation of the resultant bubble, the 1884 Corporations Act introduced significant reforms. The 1897 HGB integrated the new corporate law, along with some small reforms, into the *Reich*'s business code.

Several other enterprise forms warrant brief discussion. Following French practice, some German entrepreneurs organized 'share partnerships', a form of limited partnership with tradable shares representing limited-partnership interests. This form offered some of the advantages of the corporation, but did not (in certain times and places) require state permission. Efforts to regulate the share partnership influenced the treatment of corporations. Another corporation-like enterprise form, the *Bergrechtliche Gewerkschaft* (bG), reflected older practices for mines. The bG remained popular for mines until liberalization of corporation laws, and also underlies the *Gesellschaft mit beschränkter Haftung* (GmbH), a limited-liability form well-suited to small- and medium-sized enterprises (SMEs). The GmbH's introduction in 1892 reflected perceived limitations in corporate law. Finally, cooperatives play an unusually important role in the German economy today and in the past. Two innovations (1867 and 1889) bolstered their legal status. Both cooperatives Acts reflected and advanced the development of enterprise law for businesses.

1. PARTNERSHIPS BEFORE THE ADHGB

The Prussian ALR reflects its roots in the mid-eighteenth century and its attempt to provide a comprehensive treatment of all realms of law: for commercial matters the ALR is sketchy. Business partnerships appear only as a special case of the broader category of 'permitted associations' (*erlaubte Privatgesellschaften*), voluntary associations for some private end. So long as the association's purpose was legal and did not harm the common good, the association was permitted.[5] The written agreement among the association's members constituted a binding contract for those individuals, but the association could not act as a body with respect to others. These rules applied to all associations, including civil-society

[5] Like most German states, Prussia strictly controlled or even forbade the creation of civil-society groups until the early twentieth century. The definition of 'harming the common good' could be broad. See Brooks and Guinnane (2017).

groups (such as gymnastic associations or choral societies), as well as to business firms.

Without special privileges, the ALR's permitted association was not a 'moral person' (*moralische Person*). Neither was it the more demanding 'legal person' (*juristische Person*). The distinction between moral and legal persons appears regularly in nineteenth-century discussions of the proper way to treat business associations. Full exploration of these concepts would take us far afield: they relate to the theories of the corporation described below. Baums (1981, p. 21) offers a succinct explanation that suffices for our purpose. A moral person amounts to a society's entire membership for legal purposes. The moral person is not merely the society's representative, although, of course, the society typically names individuals to manage or represent its interests. A legal person, on the other hand, exists separately from the society's membership. Lack of moral personhood meant that a permitted association could not act as a body at law: typically, the individual members had either to appear in person at proceedings, or to provide a power-of-attorney to act on their behalf. The state could, however, grant associations a special privilege, the rights of moral persons. One way to see this subtle difference is to consider the text of the 1861 ADHGB (discussed below). The partnership, a moral person in the ADHGB, can enter into contracts and own property 'in its own name'. (§111). The corporation, a legal person, 'as such has its independent rights and duties', which include the ability to enter into contracts and own property (§213).[6]

Business entities appear in a short, separate section as special cases of the permitted association (II, VIII). Since the ALR does not really contemplate business corporations, the 'enterprise' here means a business partnership. (We return to the ALR's corporation below.) The code views the default multi-owner enterprise as a partnership in which all owners have unlimited liability. The ALR (II, VIII (§651)) also establishes a limited-partnership form. The partnership could be bound both by contracts signed by all partners and by individual owners. Registration requirements only applied to larger, more durable businesses, however, and registration ordinarily meant informing the local mercantile community (*Kaufmannschaft*) of the firm's existence. There was as of yet no state-run commercial registry.

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[6] §111: 'Die Handelsgesellschaft kann unter ihrer Firma Rechte erwerben und Verbindlichkeiten eingehen …' §113: 'Die Aktiengesellschaft als solche hat selbständig ihre Rechte und Pflichten …'

French occupation of western Germany during the coalition and Napoleonic wars posed challenges for Prussia and other states that acquired new territories in 1815. After years of French rule, many in what became Prussia's Rhineland province had little desire to join relatively backward Prussia. To mollify them, Prussia permitted the Rhineland to retain some local institutions, including French law.[7] French commercial law exerted considerable influence on German states in the eighteenth century, and the Rhineland was not alone in retaining or heavily borrowing from French law. The *Code de Commerce* delineated three types of firm: the ordinary partnership (*La société en nom collectif*); the limited partnership (*La société en commandite*); and the corporation (*La société anonyme*). Owners in an ordinary partnership have unlimited liability (§22), while limited partnerships have two types of owners, those with unlimited and those with limited liability (§23). The limited partners could not participate in management (§27) upon pain of being held unlimitedly liable for the firm's obligations (§28). If the limited partnership has several ordinary partners then the rules governing their relations among one another are those of the ordinary partnership (§24). The *Code de Commerce* (§22) also permitted any ordinary partner to bind the partnership with respect to third parties, thus allowing the firm to enter into agreements without the signatures of all owners.

The ALR and the *Code de Commerce* between them governed only parts of the German commercial world in the early nineteenth century. Some states (such as Baden) explicitly incorporated the French codes as their own governing law, while in others, French law influenced without being explicitly embodied into law. For most of the remainder of Germany, however, the relevant law remained the *Ius Commune*, the uncodified law based on the 'reception' of canon/Roman law, partially supplanted by specific regulations or law.[8]

2. CORPORATIONS BEFORE THE ADHGB

The central controversy for corporation law during much of the nineteenth century in Germany turned on a question that few see as relevant today: whether the state had to agree for entrepreneurs to form a corporation. Until 1870, most German states required each group of

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[7] Westfalia had also been under French occupation, but an Act of 21 June 1825 introduced the ALR there (Bösselmann 1939, p. 63 note 2).

[8] *Ius Commune* (in German, *gemeines Recht)* means, literally, 'common law,' but the *gemeines Recht* bears no relation to the English common law.

entrepreneurs seeking to use the corporate form to obtain permission to do so. The terms used to describe these permissions can be confusing; here I use the general rubric ‘concession’. Concessions were not unique to Germany. The requirement appears in the relatively modern *Code de Commerce* (§37). The few countries that allowed free access to the corporation remained exceptions until after the middle of the nineteenth century. The U.S. led this movement; Hilt (2017) describes two waves of general incorporation statutes in U.S. states (1811–24 and again 1836–37). Among large European countries, relatively backward Spain first provided free access to the corporation in its 1829 Commercial Code.[9] Britain allowed firms to incorporate without concessions starting in 1844 but did not grant such firms limited liability until 1855 (Harris 2000, p. 288). Neither Russia nor Austria abandoned the concession system until after World War I.[10]

Legal changes defined three regimes. Early-modern states granted specific privileges to individual firms, and those privileges might include favored legal status. This practice accounts for the few corporations Prussia established in the eighteenth century.[11] These special charters (*Oktroi*) shaped firms on a one-off basis. The *Oktroi* could confer some but not all the usual rights of a corporation (for example, acceding to the corporate form but denying shareholders limited liability) as well as other privileges such as exemption from certain taxes or the creation of a monopoly (Baums, 1981, p. 28). The system of firm-specific privileges persisted until the systematic corporate law found in the *Code de Commerce* for France, or in Prussia’s 1843 Corporations Act. Such measures defined a second regime: the state still controlled access to the form, but under this concession (*Konzession*) system, entrepreneurs applied for corporate status in a bureaucratic, regularized process. The resultant corporations organized under standard legal rules spelled out in the Act. The final step reflected what the English-language literature calls general incorporation: any group of entrepreneurs who adhered to a set of

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[9] This provision was repealed in 1847. See Guinnane and Martínez-Rodríguez 2014 and Martínez-Rodríguez in this volume.

[10] On Russia, see Gregg (2016); on Austria, Kalss et al (2003).

[11] The first two corporations Thieme (1960, p. 202) identifies were sugar refineries in Breslau (chartered 1770) and in Königsberg (1782). The *Seehandlung*, created in 1772, at first had a monopoly on certain trade with Prussia. The *Seehandlung* was unusual in that the Crown owned all but 300 of its original 2400 shares (Hellwig 1911).

rules (*Normativbestimmungen)* could incorporate.[12] Under general incorporation regimes, governments could and did apply different rules to firms in different sectors.[13]

Developments in corporation law reflected practical concerns about investor protection and other issues that remain important today. Underlying the debate, however, was a broader theoretical concern about the nature of the corporation itself. The literature distinguishes several different views, but two are most important for the approach to the corporation in our period. One view ('concession' or 'fictitious personality' theory) viewed the corporation as a creation of public law: the state created corporations and granted them specific, limited powers as a matter of public law. A second view ('real-entity' theory) holds that the 'real existence' of a group makes it a legal person. These distinctions reflect a divide in German legal thinking. Friedrich Carl von Savigny (1779–1861) is credited with pioneering a scholarly approach to the application of Roman-law principles for German legal questions. Savigny and his adherents saw the concession theory as most consistent with Romanist legal notions. Although he attributes the idea to others, Otto von Gierke (1841–1921) most famously developed and defended the real-entity theory. For the basis of law Gierke looked to German history and what he viewed as long customs among Germanic peoples. To Gierke, the State could not create corporations, because they already existed as social entities; the state could only recognize corporations' existence as manifested by the actions of citizens.[14]

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[12] The terminology here differs from the usual English-language literature in part because the Anglo-Saxon countries appear not to have had strict parallels to the *Konzession*. Hilt (2017)'s careful study of U.S. incorporation uses the term 'special charter' for the practice in which a state legislature approves corporate charters on a firm-by-firm basis. Pennsylvania's 1836 statute for iron manufacturers appears to parallel what the German literature calls the *Konzession*: each application required the agreement of the governor and attorney general. Analogous practices ('chartering under general acts') were common to several U.S. states in the 1830s (Hilt 2014).

[13] U.S. states also created more liberal standard incorporation rules for specific sectors. See Hilt (2017).

[14] The English-language literature may make more of the practical significance of these distinctions than is warranted. The brief remarks in the text can only point to a debate that had much broader concerns. Harris (2006) provides an overview and guide to how this debate shaped U.S. and British discussions. Whitman (1990) is an account of the Romanist/Germanist divide and its implications for the development of German law in this period. Maitland translated part of the third volume of Gierke's four-volume *Das Deutsche*

We focus on the practical implications of the debate. Some arguments for concessions imply that the state must protect its citizens from unscrupulous business people, and thus have a modern feel.[15] Permission to organize as a corporation reflected some degree of state approval for the business itself, and in many cases, approval came with the requirement that the firm accept one or more government officials as an internal overseer (*Kommissar*). The *Kommissar* might exercise a general right to attend and take part in meetings. Concessions ordinarily had a fixed end date, and in any case the state could withdraw them if it saw fit. Other arguments for concessions turned on the effect unrestrained incorporation could have on other, smaller firms. The early nineteenth century witnessed parallel arguments over the abolition of guilds (*Gewerbefreiheit*) and freedom of movement between occupations and places. Some governments worried that the large firms implied by incorporation would drive smaller producers out of business. In its report on the draft of the 1843 Prussian Corporations Act, the king's council defended concessions on the grounds that the corporation's size allowed it to suppress all competition from competing firms.[16] This fear of the overweening power of large enterprises united otherwise contending groups. Both agricultural interests and those of small business had reason to fear the scale corporations could achieve (Wehler, 1995, p. 104).

Contemporaries debated the right criteria for corporate status. Most favoring a concession system agreed that the state should assure itself of the founder's moral qualities, and that a firm should not become a corporation unless it had capital available to execute its plans. Answering these questions did not address the issues raised by the theories of the corporation noted earlier. Should firms be granted corporate rights simply because this form best allowed them to make money? Or should the state

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Genossenschaftsrecht into English. Gierke's history is in total more than 3500 pages long; only the last volume contains brief discussion about the specific issues in question here. Maitland's introduction serves as a useful overview of Gierke's core idea.

[15] Thiessen (2009, B) stresses that early nineteenth-century regulation of corporations reflects above all state suspicion of this form. Citations to this unpublished work use section numbers because pagination in the final version will not be the same.

[16] '… die Aktiengesellschaften, vermöge ihres Übergewichts an Kapital, die einzelnen Gewerbe- und Handeltreibenden, welche demselben Gegenstande und Zwecke ihre Thätigkeit widmen, unterdrücken, jede Konkurrenz beseitigen und so zum Nachteile des Gewerbe-und Handelsstandes, wie des gesammten Publikums, ein Monopol erlangen würden.' Reprinted in Baum (1981), p. 84 of original, reprint p. 141.

restrict corporate status to enterprises that served a public end that might otherwise go unserved? The latter view, which held sway at least in the early decades of the nineteenth century, reflects the idea that incorporation is a gift from the state. Using private investment to fund infrastructure (such as railroads) appealed to German governments burdened by the debt incurred during the French wars.[17] The Prussian minister responsible for corporations explained to the king in 1831 that he only wanted corporations that served a public end (*gemeinnütziger Zweck*).[18] Martin (1969, p. 514, note 59) recounts the experience of a porcelain factory in Saarbrücken denied a concession in 1835 because it did not reflect any 'outstanding importance' and the factory in question was one of many in the region. It thus does not surprise that many early corporations undertook infrastructure projects. Martin (1969, Table 1) reports that of the 76 corporations chartered prior to 1843, 20 were for infrastructure projects such as bridges, 18 were for insurance, and another nine for raw materials such as coal.[19]

Some German states, including many of the Hanseatic city-states, did not require concessions for corporations. They traced their positive experience with corporations to the virtues of public vigilance, arguing that state supervision could actually endanger investors: if the state oversaw corporations, the public would not, and only the public could really keep a corporation on the right path. Proponents of general incorporation also noted the expense entailed in the application process itself. Concessions required 'protracted and arduous' ('*langwierigen und mühsamen*') negotiations (Bösselmann, 1939, p. 64). These costs reduced the return on invested capital, and probably deterred firms from seeking incorporation in the first place. Reich (1969, p. 246) points to the vicious circle the long delays created: to obtain the concession, the promoters had to have shares subscribed, but by the time they had obtained permission to go forward, investors might have found other uses for their money.

By giving the state the right to decide which firms could incorporate, the concessions system invited corruption and political chicanery. Some

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[17] Ludwig von Vincke, the governor (*Oberpräsident*) of the Prussian province of Westfalia, pushed hard to use the corporate form and private money to improve roads and other transport infrastructure in the first decades of the nineteenth century. He viewed the English turnpike trusts as a model (Wischermann 1992, pp. 280–84). Sicken (2016) discusses efforts to use the corporate form to gather private investments in military facilities in this period and later.

[18] Quoted in Baums (1981, p. 28).

[19] Counts of corporations in this era are not complete. See below.

firms granted a concession had suspiciously large numbers of government officials and military officers as investors. Creation and renewal of the analogous English firms (such as the East India Company) involved more than a little corruption.[20] Control over access to the corporate form could also be used to reward friends and punish enemies. The early history of the *Diskontogesellschaft* illustrates the problem. David Hansemann, a successful Rhineland businessman and Liberal political figure, wanted to organize the firm as a corporation, but the negotiations over the required concession went nowhere. Hansemann's political enemies in government feared the new financial institution's success would increase his influence in Berlin, and they used their control over the chartering process to frustrate the plans of the 'hated and feared agent of Liberalism' (Däbritz, 1941, pp. 8–12). The *Diskontogesellschaft* first came to life as a share partnership.

A Legal Framework for Corporations

The ALR does not contemplate business corporations. Rather, Prussia issued *Oktrois* creating 'privileged associations' (*priviligierte Gesellschaften*) under the authority of II, VII (§16–29). Because these clauses assumed that each *Oktroi* would be tailored to the specific association, the ALR contains little language about internal governance or other matters. The *Code de Commerce*, in contrast, defined the corporation and provided some structure.

Prussia's first legislation on corporations applied to railroads only. The development of steam railroad technology starting in the late 1820s demonstrated the potential this transportation mode offered a region with poor roads, relatively few canals, and river systems that served some areas well and others not at all.[21] The customs union (*Zollverein*) created in 1834 made the railroad's appeal that more urgent; as German states dropped their tariffs against one another, transportation costs loomed

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[20] Martin (1969, p. 517) notes several German examples, including the chief of the general staff. In another context (in 1838) the governor (*Öberpräsident*) of the Rhineland expressed irritation at the number of government officials pushing for a corporate charter in which they had a personal interest. The literature on England's chartered trading companies stresses this theme. According to Sutherland (1947, p. 18), the East India Company's need to secure and renew its charter left it 'deeply and painfully experienced in the technique of political intrigue both with monarchy and parliament'.

[21] The date of the 'first railroad' depends on the definition of railroad, but most accounts agree that the first steam-powered railroad opened in England in 1825. The first such railroad in Germany connected Nürnberg to Fürth in 1835.

relatively larger as a cost of intra-German trade. After some initial opposition the Prussian, like most German governments, sought to encourage railroad development. What followed reflected an older policy intended to encourage private enterprise to build metaled roads (*Chausee*) to save the cash-strapped state the need to invest its own resources.

Building a railroad required the state's legal assistance in two ways.[22] To contain construction costs many railroads needed to follow specific paths, but obtaining access to those routes offered landowners the chance to extract significant payments for required through rights. The state could force sales at terms more advantageous to the railroad. Railroads also had financial requirements especially suited to the corporate form. The railroad's capital needs often exceeded anything contemporaries had seen to date. Obtaining these sums through partnerships would require large, unwieldy firms. Building a railroad also required significant investments before any prospect of significant cash flow; unless the capital is 'locked-in', the railroad firm faces significant problems in ensuring the project can be completed.[23] After some years of approving railroad projects on a case-by-case basis, the *Oktroi* approach, the Prussians enacted a measure that codified general rules for new railroads. Most of the 1838 Act pertains to issues other than the corporate form, but the law marks the first standardization of the corporate form in Germany. The 1838 Act required a concession, but in this case the concession usually concerned rights beyond those of the corporate form.[24]

Prussia's 1843 Corporations Act extended this approach to all sectors. The Act required the state's permission for each corporation to form (§1), to change its statutes (§4), or to wind-up business (§28(3)), but it provided standard rules for the firm's creation and structure. Corporations had to publish their articles of association in the local official newspaper (§3), and the corporate name had to refer to its activities, not its founders (§5). The Act also introduced two new provisions intended to protect the firm, its owners, and creditors. §15 explicitly gave owners limited liability, at the same time freeing the firm from any demand for repayment of capital so long as the firm operated. In addition, the Act separates the firm from its owners by stating that an owner's death does

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[22] Bracht (1998) traces the history of early railroad construction in Prussia.

[23] For the advantages of the corporation for specific investments, see Blair (2003) and Blair and Stout (2005).

[24] The entire 1838 Act consists of 12 pages, of which one page pertains to the corporation as such. Bösselmann (1939, p. 69) notes the existence of corporations created in 1818 (in the Rhineland) and in 1821 (in Danzig, which was under the ALR) without concessions.

not trigger the firm's demise (§28). The state's concession made the corporation a legal person (§8). But the 1843 Act required no minimum total capitalization or share size, and the law said little about the corporation's internal organization or governance. A committee of directors (*Vorstand*) are contemplated by §19–§24, who run the firm and represent it to others. Otherwise the firm's articles of association establish, for example, the voting rights of shareholders.

Both the 1838 Railroad Act and the 1843 Corporations Act applied to all Prussian territory, and thus made a first step toward legal uniformity in that kingdom. The *Konzession* approach embodied in the 1843 Prussian law offered, in a different kind of uniformity, an important advantage over the *Oktroi* system. The Act allowed entrepreneurs seeking corporate status to shape their application to the law's requirements. The officials overseeing the *Konzession* decision could develop and apply general knowledge about the corporation as a form, allowing more systematic and predictable decisions. And for the investing public, the new approach went a long way toward standardizing corporations and thus their shares. Under the *Oktroi* approach, the lack of any kind of uniformity forced potential investors to evaluate each corporation as a distinct legal beast.[25]

While still requiring a concession, the new law did lead to more charters. The total number of corporations chartered remains the subject of some uncertainty. Reckendrees (2012, Table 2) compares the earlier estimates and corrects some omissions. Prussia had been especially reluctant to charter corporations before the 1843 Act. In the period before 1843, Prussia had chartered 90 corporations in all, 59 in the years 1830–43. Between the 1843 Act and 1860, Prussia chartered a further 268 corporations, more than three times as many per year as before 1843. The relatively small Rhineland accounted for 41 corporations before 1843, compared with 35 in the rest of the kingdom.[26] The 1840s were also a good time to raise capital from external investors. Interest rates on

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[25] Kalss et al (2003, pp. 107–25) offer a thoughtful discussion of the *Konzession* system, in an Austrian context.

[26] Reckendrees (2012, Table 3) notes that the Rhine province saw far more corporate foundations *per person* than the rest of Prussia. Martin (1969, p. 242) stresses the greater number of corporations as a reflection of the *Code de Commerce*. The causation is unclear; the Rhine province was also the most economically developed region at the time. Reckendrees follows earlier practice in excluding turnpikes (*Chausee*). The Rhineland/Prussia figures come from Martin (1969, Table 1); Reckendrees shows these figures suffer some omissions. See also Thieme (1960).

Prussian bonds had fallen considerably by the early 1840s, making the higher (if riskier) returns available from corporate shares relatively attractive. The Prussian officials chose well; Martin (1969, p. 507) notes that as of 1896, fully half of the corporations chartered before 1850 still operated.

Alternatives to Corporate Concessions

Some German states took a more liberal approach to the corporation. The Hanseatic city-states had early on adopted an approach to company formation that permitted entrepreneurs considerable flexibility, so long as they made their articles of association available to the public. In Hamburg and Bremen, entrepreneurs could freely modify other forms such as the limited partnership (*Kommanditgesellschaft*). Freedom to create corporations reflected a general approach to company law in these states; firms had to provide information on what they did, but were not highly constrained by specific rules (Martin, 1969, p. 511).

In states that required a concession for the corporation, entrepreneurs could instead use a similar enterprise form that did not require a concession. The share partnership (most famous as the French *Société en commandite par actions*; in German, the *Kommanditgesellschaft auf Aktien* or KGaA) shares the basic structure of a limited partnership. The firm has one or more general partners (the *Komplementäre*) who bear unlimited liability and run the enterprise. The limited partners (*Kommandisten*) own liquid securities similar to a corporation's shares. A KGaA could be quite large and amass investment from thousands of dispersed owners, just like a corporation. While not a full substitute for the corporation, the KGaA offered a way for entrepreneurs to achieve part of what they would like from a corporation without the need for a concession. The 1843 Prussian Act does not mention the KGaA, adhering to the earlier doctrine that it is a variant on the limited partnership. The share partnership played an important role in French company organization, largely because it did not require a concession (Freedeman, 1965).[27] German entrepreneurs organized far fewer share partnerships than their French counterparts, but efforts to control the KGaA played a direct role in approaches to corporation law.

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[27] Freedeman (1965, Table 3.1) reports 1779 share partnerships created in France in the period 1826–37 alone. There are no comparable figures for German states.

3. UNIFORM COMMERCIAL LAW

Until 1861 each German state had its own commercial law. That situation changed when the members of the German *Bund* agreed on a single commercial code called the *Allgemeine Deutsche Handelsgesetzbuch* (ADHGB).[28] The ADHGB project reflected two general concerns. For many Germans intent on political unification, all-German legal codes seemed like an important first step. The ADHGB also reflected a fear of legal 'races to the bottom'; because the *Zollverein* allowed firms to establish in one state and export to the rest of the union, lax legal rules in some member states threatened to undermine controls everywhere.[29]

The *Bund* assembled a committee to hammer out a code in Nürnberg starting in 1857. Prussia (along with other states) had been at work on its own revised commercial code. That fact alone probably lent some weight to the Prussian proposals. In addition, because of its 1843 Corporations Act, Prussia had alone had extensive experience with legislation that defined the rules for corporations. Prussia's draft for a revised code became the starting point for the ADHGB, and the corporation section of the draft brought to Nürnberg consisted almost entirely of the 1843 Prussian corporations Act.[30]

Some of the ADHGB's provisions reflected old practices that the new Code made standard. The ADHGB required the creation of a commercial registry and specified rules for the registration of firms there. By extending the requirement to all firms and to all of Germany, the

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[28] The *Bund* had little real authority, but provided a suitable forum for working out details when the major states agreed on something.

[29] One famous example of this process, the Darmstädter Bank, was founded in Darmstadt in 1852, even though its logical headquarters would have been Frankfurt. But a universal bank on the *Crédit Mobilier* model threatened Frankfurt banking interests. August von Mevissen and his co-founder Abraham Oppenheim obtained the necessary permission in Darmstadt, some 20 miles from Frankfurt (Cameron 1956); see (Däbritz 1931, pp. 42–3).

[30] La Porta et al (2000, p. 23) claim that the new code was part of an effort to extend state control: 'In France and Germany, by contrast, parliamentary power was weaker. Commercial Codes were adopted only in the nineteenth century by the two great state builders, Napoleon and Bismarck, to enable the state to better regulate economic activity. Over time, the state maintained political control over firms and resisted the surrender of that power to financiers.' At least for Germany this passage is perplexing. German Liberals favored codification as a way to limit the power of local elites. Bergfeld (1987, pp. 101–14) describes Prussia's role in creating the ADHGB. Kraehe (1953) stresses Bismarck's *opposition* to the code.

ADHGB made it possible to endow partnerships especially with powers they had hitherto lacked. The register was public (§12) and every business person (*Kaufmann*) had to enroll and provide basic information. Changes in the firm's name or ownership required updates at the register (§25), making it possible for interested parties (such as potential creditors) to obtain basic information at very low costs.

The ADHGB also provided detailed rules that distinguished (for the first time in Prussia, given the ALR's brief treatment) the ordinary partnership (*Offene Handelsgesellschaft* or OHG) from the limited partnership (*Kommanditgesellschaft* or KG) and the silent partnership (*stille Gesellschaft* or sG). The basic distinctions survived the nineteenth century and remain in effect in Germany today. All the OHG's owners have unlimited liability. The KG has general partners with unlimited partners, as well as other partners (*Kommandisten*) who have limited liability. The sG differs from the KG in that the former is an investment contract rather than a firm. Investments taking this form do not appear in the commercial registry. These forms are based on the distinctions made in the *Code de Commerce*, but the ADHGB distinguishes the KG and sG in a way the French Code did not.[31]

The ADHGB's partnership rules differ in an important respect from those created under the *Code de Commerce*. An ADHGB partnership can, in its own name, contract with others, buy and sell property (including land), and sue and be sued (§111); it is a moral person. This automatic grant of moral personhood did not sit well with all delegates (Thiessen, 2009, B(II)1). The public register gives this language real force. The partners who have the right to speak for the firm can do so on all 'business and legal matters'. Conversely, agreements by partners who do not have the right to represent the firm have no legal force (§22), a rule supported by the information available in the registry.

Individual partners had expansive grounds to demand the firm's dissolution, including the impossibility of achieving its original purpose and the neglect or incompetence of other owners (§125). Thus the partnership suffered the problem of 'untimely dissolution' detailed in Guinnane et al (2007). Partnerships could dissolve because of a partner's death or bankruptcy, and their lack of capital 'lock-in' meant partnerships were ill-suited to specific investments. The ADHGB's partnership also lacked what Hansmann et al (2006) call entity status: if any owner

[31] The ALR does not distinguish between the KG and the sG; it refers to the same form by the French term for limited partnership (*Société en commandite*) and the German term *stille Gesellschaft*. See Röder (2014) for the KG.

became bankrupt, his firm automatically dissolved (§123). Limited liability protects the firm's owners from its creditors. Entity status, on the other hand, protects the firm from the personal creditors of its owners.

The Corporation in the ADHGB

Because the ADHGB started with a Prussian draft code, the 1843 Prussian Act became in effect the basis for corporate law throughout Germany.[32] The corporation's shares could be named or bearer shares (§207). While not using the phrase 'legal person' that appeared in the 1843 Act, the ADHGB (§213) affords the corporation the right to act as an entity. The code does not require a minimum value for each corporate share nor a minimum capitalization for the enterprise. The ADHGB's corporation could, optionally, have a supervisory board (*Aufsichtsrat*) in addition to its obligatory managing board (*Vorstand*).

Sharp disagreements over the question of concessions threatened to derail the project; Prussia and Austria, among others, insisted on the requirement, while other states insisted on the opposite. Hamburg offered a spirited defense of free incorporation, using arguments that would soon seem prophetic. The corporation, its representative acknowledged, could be the source of evils, but in adopting measures that would hinder its growth, the Code would introduce a cure worse than the disease. More generally, there is only one solution to the problem of corporate abuse: 'public experience'.[33] The drafting committee saved the proposed Code by making corporation law uniform, while allowing each German state to decide on requiring concessions (§181). Most states retained a concession system. Of those opting for general incorporation, only Württemberg and Saxony were of any size, although Saxony was already an important industrial region. The remaining states opting for general incorporation were either small (Oldenburg) or Hanseatic city-states (Hamburg, Bremen, and Lübeck).[34]

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[32] Thiessen (2009, A) calls the ADHB the '*Code de commerce ferroviaire prussien*' because of the influence of the Code de Commerce and the 1838 Railways Act.

[33] Deutscher Bund (1857). 'Protokolle'. 9 v. (1 p.l., 5152 p.), pp. 319–23.

[34] Fick (1869, pp. 406–7) reports the decisions about concessions as follows: for both the KGaA and the corporation, Lübeck, Oldenburg, Bremen, Hamburg, Baden, and Württemberg dropped concession requirements. Baden and Württemberg retained concessions for banks and insurance companies. Prussia, Frankfurt, and some smaller territories retained the requirement for corporations but not

While muted in the ADHGB, we can see in these first all-German corporation rules the inklings of what later became characteristic for corporations and the GmbH: a concern with the enterprise's capital stock (*Kapitalschutz*). The corporation, under §217, is forbidden from promising specific dividend rates to shareholders, on the assumption that meeting such obligations might force a poorly-performing firm to pay dividends out of capital rather than profits. The corporation, under §209(4), is required to list its authorized capital (*Grundkapital*) in its articles of association. Preserving this capital would provide creditors a solid basis for lending to the firm.

The ADHGB also introduced the first legal rules for the share partnership in most German states. In its *Motiv* for the proposed 1857 commercial code, Prussia argued that if the KGaA did not require a concession, firms would use the form as a way to avoid concession requirements for corporations – as they indeed already had.[35] The ADHGB treats concessions for the KGaA in the same way as corporations. Prussia waived concessions for the KGaA while keeping them for corporations, a combination adopted by several other states. The rules governing the KGaA were tougher than for corporations. The share partnership could not issue bearer shares, and each share had to have a minimum value of 200 Thaler (§173).[36] The situation where an investor contributes something other than cash (a prior business, perhaps, or land or other input) is governed by §180. The share partnership's mandatory supervisory board had at least five members. The more stringent rules for share partnerships written into the ADHGB reflect the expectation that most states still controlled access to the corporation. But the effect was to subject the KGaA to more stringent norms.

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share partnerships, and Hannover and the other territories incorporated into the North German Confederation adhered to the Prussian rules.

[35] The Motiv appears as the second volume of the draft code (cited here as Prussia 1857). The remark is on p. 81.

[36] Assuming one Thaler = three Marks (the exchange rate used when the Mark was created in 1873), this is 600 Marks; per-capita net national income in Germany in 1861 was less than 250 Marks. (Compare Hoffmann et al 1965, Table 1 (p.172) and Table 248 (p.825).)

4. GENERAL INCORPORATION AND ITS DISCONTENTS

General incorporation came to all of Germany soon after the ADHGB and its compromise.[37] The 1870 Corporations Act dropped the concession requirement entirely, replacing it with stronger regulation of the corporate form. This change, barely nine years after the hard-fought defense of concessions written into the ADHGB, reflects several forces. In defending the introduction of general incorporation, the *Motiv* for the 1870 Act lays out three reasons for concessions: the apparent legal contradiction of creating legal persons without specific state permission; the need to protect the public, both equity investors and creditors; and the need to protect smaller enterprises and the general welfare.[38] It then argues that the first issue has been made moot. The ADHGB extended the ‘important rights’ of legal persons to enterprise forms that did not require a concession.[39] In his 1870 speech to the German Legal Association (*Deutscher Juristentag*), Levin Goldschmidt, perhaps the most influential commercial lawyer of the time, defended the notion of extending these rights to broad classes of enterprises as a defense of private liberty. Goldschmidt also addressed the theoretical concerns about the corporation noted above, stressing that the state should not be in the position of judging private associations and deciding what rights they should enjoy. On the second point, the *Motiv* adopts the argument seen earlier in Hamburg’s protests to the commission drafting the ADHGB: the state cannot serve as a useful protector of investor interests, and in pretending to fulfill this role reduces private vigilance. Goldschmidt dismissed the second, regulatory (*polizeilich*) function as requiring the state to investigate the moral qualities of corporate founders and to investigate their proposed firm’s prospects, purposes to which the state’s apparatus is not

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[37] This discussion relies in part on Lieder, J. (2007). ‘Die 1. Aktienrechtsnovelle vom 11. Juni 1870.’ *Aktienrecht im Wandel* 1: 318–87.

[38] Ordinarily the government’s initial draft for legislation includes a document (the *Motiv* or *Begründung*) explaining its view of the need for the new law as well as defense of particular provisions. In this case, see Deutsche Reichstag xx, pp. 650–51.

[39] The *Motiv* names the ordinary and limited partnerships. The 1867 Prussian Cooperatives Act did the same for that enterprise form, which was not included in the commercial code; see below.

well-suited.[40] The *Motiv* addresses the third concern by noting that enterprises organized under other legal forms can achieve considerable size and pose the same dangers to smaller firms.

The implicit admission that the state had failed to make concessions workable also reflects broader issues. The local opt-outs allowed under the ADHGB created a lack of legal uniformity that seemed inappropriate to the new national state. Many Germans saw the newly united Germany as an instrument that could deliver economic growth that would match England. Amassing capital in large corporate enterprises would advance that goal.

The *Oktroi* and *Konzession* systems made the state the primary guarantor of corporate behavior. Once the state stepped back, the law had to provide a structure that would enable other entities, presumably shareholders and corporate organs, to regulate their own affairs.[41] The 1870 Act attempted to provide this structure largely by applying to the corporation the ADHGB's approach to the share partnership. We can group the most important provisions under three headings: the enterprise's capital; its governance organs; and the penalties for misconduct.[42] The ADHGB did not set a minimum share value for corporations; the 1870 Act specified 50 Thaler for named shares and 100 Thaler for bearer shares (§207a).[43] These figures represent compromises between those who wanted no minima, and those who argued that the sums should be greater. Large share values would have excluded less sophisticated (and thus more vulnerable) investors but made it harder for firms to raise capital.[44] There was also some concern that the public would use very small shares as substitutes for bank notes. The minimum share plus the

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[40] The meeting transcript indicates amusement (*Heiterkeit*) at this point. Goldschmidt's remarks are in (1860). 'Verhandlungen des Deutschen Juristentages.' v. (1870, pp. 43–53). The 1870 *Motiv* actually states that by reducing shareholder vigilance, the state exacerbates the problem. See Schubert (1981, pp. 287–8).

[41] Thiessen (2009, C(III)) observes that with the end of concessions, rules and exceptions switched places.

[42] This organization follows Lieder (2007, pp. 340–74).

[43] The clauses in the 1870 and 1884 Corporation Acts are numbered to reflect the provisions they replace in the ADHGB; the 1870 Act begins with §173, for example.

[44] Much earlier, in 1829, the Berlin *Kaufmannschaft* had argued the opposite: that one virtue of corporations was the chance for higher dividends that shareholding offered poorer households. Quoted in (Reich 1969, p. 248).

obligatory supervisory board (all of whose members had to be shareholders in 1870) meant that German corporations had, for the first time, a minimum capitalization. In taking this approach, Germany was not alone.

Other provisions also reflect heightened concern for *Kapitalschutz*. One rule required that a new corporation's capital had to be fully subscribed before any shares were issued (§209a). Another required that a corporation could not register (and thus operate) until at least 10 percent of its total capital had been paid in. A higher sum might have prevented formation of corporations as purely speculative ventures, but the lower sum encouraged the investment the government wanted. Corporations after 1870 faced a requirement adapted from the ADHGB's treatment of the KGaA; the original subscribers had to pay in at least 40 percent of each share's value before the firm could release them from liability for the remainder.[45] Permitting this '*Aktienliberierung*' made the shares more liquid, but again, the figure reflects a trade-off. Requiring a higher sum would make it easier for others to evaluate the firm's total capital, but a higher sum would also deter potential shareholders who feared the full commitment (§209b). The Act also regulated the common practice whereby some founders purchased their shares not with cash, but with real property, the assets of an earlier business, or patent rights. Many new corporations reflected the conversion of an earlier enterprise. The articles of association (*Gesellschaftsvertrag*) had to spell out all such in-kind contributions (*Sacheinlagen*) and the value assigned to them. This procedure aimed to prevent founders from over-valuing their in-kind contributions. Finally, the articles of association had to enumerate any special privileges granted to specific owners (as reward for the foundational activities, most often) (§209b). To give these provisions force, the Act required a special, founding meeting of the shareholders (*Generalversammlung).*

The 1870 Act introduced new internal control measures to substitute for the state's former role. The most important made the supervisory board obligatory (§209-6). The law intended the shareholders to exercise more power and oversight within the firm than before, and treated the *Aufsichtsrat* as the organ deputized to do so. This provision reflects an adaptation from the AHDGB's treatment of share partnerships, where the supervisory board reflected that form's 'monarchical' structure: the general partner(s) run the firm, and the shareholders have only limited

[45] The ADHGB required KGaA shares to be *fully* paid in before issue. For 1870 corporations, this provision only pertained to bearer shares (§222).

rights. Translating this organ to the corporation met some opposition; in particular, by requiring that all three members own shares, the provision effectively placed a minimum on the corporation's size. §225a assigns the supervisory board two roles: it oversees the firm, and prepares yearly financial statements for the shareholders.

The new law introduced criminal penalties (both prison and fines) for the firm's founders and managers if they knowingly falsified information about the capital's subscribers, failed to appoint an *Aufsichtsrat*, or misrepresented the firm's conditions to the shareholders. The same applied if the managers ignored §240, which applied if the firm lost at least half of its capital or if its capital exceeded its debts. These provisions (in the entirely new §249) reflected the new norms written into the 1870 Act: the state could not supervise corporations directly, it had to create incentives for those involved to behave correctly.

The 1870 *Motiv* anticipated that the end of concessions would introduce a period of heightened problems in the stock market. States such as Hamburg that already had free incorporation rejected this fear, as well as much of the new regulation written into the 1870 Act.[46] But Germany's initial experience with general incorporation turned out to be much worse than the government had contemplated. Prior to 1871, there had been a total of 203 corporations set up in Germany. In 1871, there were another 203; in 1872, 478, and in 1873, 162. The new corporations were smaller than those created before 1870. The average corporation created in 1872 had 2.5 million Marks authorized capital, compared to 4 million Marks for corporations created in 1871. The new corporations were also more than twice as likely as pre-1871 corporations to write-down their capital, liquidate voluntarily, or enter bankruptcy.[47]

The jump in new firms reflected a period of stock-market fever. Equity prices rose quickly; the available index (1870=100) reached its maximum at 186.2 in November 1872, fell to about 75 in 1877, and did not reach 100 again until the end of that decade.[48] Some contemporaries blamed

[46] At the discussions for the North German Federation's federal council, Lübeck, Bremen, and Hamburg supported general incorporation but voiced strong opposition to the new regulations for corporations. See Lieder, J. (2007). 'Die 1. Aktienrechtsnovelle vom 11. Juni 1870.' Aktienrecht im Wandel 1: 318–87, pp. 333–8 for the legislative history.

[47] The numbers quoted in the text appear in the 1884 *Begründung* pp. 237–8 Engel (1876, p. 9) reports larger figures for Prussia alone for the same period.

[48] Data on incorporations and outcomes from the *Begründung* for the 1884 Act, pp. 238–40. The stock-market index is due to Donner, but appears in Burhop (2004, Abbildung 1, p. 28).

events entirely on the end of concessions, but most recognized a more complex reality. Following its victory in the Franco-Prussia war, the German side had imposed on the French an indemnity of five billion gold francs. The French paid up, somewhat surprisingly, and did so early. The resulting capital inflow led to a reduction in interest rates in Germany and the 'founder's boom' (*Gründerboom*): new corporations whose share values were bid up until the bubble burst in the 'founder's crash' (*Gründerkrach*).[49]

Reforming General Incorporation: the 1884 Act

Calls for legal changes came swiftly and from several quarters. Not surprising, some demanded the return of concessions or other severe restrictions on incorporation. Öchelhaeuser (1876 p. 125) called for unlimited liability for the members of the *Vorstand*, an extreme but not idiosyncratic view. These and similar demands had little influence, however. Austria, which had retained the concession requirement, experienced a similar bubble. Most discussion focused on ways to remedy apparent defects in the 1870 Act.[50]

Rather than create a new approach to corporations, the 1884 Act sought to strengthen the provisions already in the 1870 Act, much of which had been easily evaded or not sufficient to the task. The 1884 Act especially strengthened provisions regarding the corporation's foundation and original capitalization. This focus reflected the widespread view that the *Gründerboom* had demonstrated an ability under existing law to profit from founding corporations that did not necessarily have much future as operating entities. The argument presumes that founders could misrepresent the new corporation's original condition. Some of the 1884 Act tries to forbid particular practices, but the more general approach is to provide more information to prospective shareholders.

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[49] Wehler (1995, pp. 98–9) notes that most of the reparations were used to pay war debts and pensions, and to bolster military defense. But by applying the French funds to these purposes, the government released other funds for investment; the direct use of the reparations matter less than Wehler claims. For more on the indemnity see Monroe (1919).

[50] Hofer (2007) discusses the 1884 Act's legislative history on pp. 390–94.Writing in 1885, Goldschmidt called the 1870 Act 'certainly no legislative masterpiece, rather an emergency law constructed in haste' ('*Die Novelle war sicherlich kein gesetzgeberisches Kuntswerk, sondern ein in der Eile gemachtes Nothgesetz.*') quoted in Lieder (2007, p. 381).

One new provision increased the minimum value of each share to 1000 Marks, a figure that applied to all shares, whether named or bearer (§207a). This more than three-fold increase over the 100 Thaler (300 Marks) required of bearer shares in 1870 had two purposes. The higher figure would supposedly ensure that shareholders had the financial sophistication to play meaningful roles in corporate governance. The figure of 1000 Marks, equal to 2.5 times per-capital net national product in 1884, might not exclude all '*Dummen*,' but it was enough to make it impossible for all but wealthy households to construct diversified portfolios out of these new shares. The 1000 Marks figure would also function as a crude investor protection. As the 1884 *Begründung* puts it, smaller savings belong in *Sparkassen* or credit cooperatives, not in risky equity investments. Some had called for even larger minimum share values. The Act's original draft proposed 5000 Marks, and Öchelhaeuser (1878, p. 50) names 10 000 Marks as his preferred figure. Germany was not alone in requiring considerable minimum share values, but the 1000 Marks figure marks a significant departure and a sharp diversion from any idea that share ownership would be widespread.

The 1884 Act's provisions reflect efforts to improve corporations in three dimensions: their foundation and capitalization; their governing bodies; and the rights afforded shareholders, including minority shareholders.[51] Changes to foundational rules reflect problems with the several methods used after 1870. In some cases, a group of founders purchased all shares in the new corporation (*Simultangründung*). Sometimes in-kind contributions played an important role (*Sachgründung*). In a third approach, the founders subscribed to all shares as required, but only made partial capital contributions (*Sukzessivgründung*). (Combinations were possible; a group could form a corporation by paying in all the required capital using physical assets instead of cash.) The 1884 Act emphasized the role of *Kapitalschutz* in preventing bad behavior and mitigating its consequences. The Act aimed to ensure the new corporation had the capital promised, and that shareholders and others could see what the founders contributed and received. One provision increased the firm's required total paid-in capital, for registration, to 25 percent (from 10 percent) (§210). The Act also did away with *Aktienliberierung*, so if a shareholder only paid in 500 Marks on a 1000-Mark share, he could only sell the share to someone who agrees to accept the responsibility for the unpaid portion. §215a adds to this provision the logical implication that

[51] This three-part distinction is due to Hommelhoff (1985). Others organize the 1884 reforms differently; see, for example, Hofer (2007).

the firm cannot increase its authorized capital until the entire figure specified in its articles of association has been paid in. §239b/185b requires a reserve fund that should eventually equal one-tenth of the value of the authorized capital. The 1884 law required more detail and clarity about founder's in-kind, as well as any special benefits founders received.

To make these (and other) provisions real, the Act required more publicity about the foundation procedures, and drew a line between the founders and their corporation. The management and supervisory boards had to verify the accuracy of the foundational procedures on the firm's behalf (§209h). In the case of simultaneous foundation, these boards verified that the putative capital had actually been paid in. The boards faced a more complex task if some capital was paid-in using real assets: the new law required detailed enumeration of the assets transferred to the firm. If the members of these bodies were founders, they had to be replaced by an auditor for this purpose. These procedures reflect the recognition that the 1870 Act had placed too much faith in the shareholders' meeting, which was not suited to detailed investigations.

A second set of provisions sought to bolster the corporation's ability to govern itself. Implicitly these rules recognized that the shareholders as a body were not well-suited to active governance. Hopes for control shifted to the *Aufsichtsrat*. The shareholders now elected this board (§224). Supervisory board members no longer had to be shareholders, permitting the owners to appoint individuals with specific expertise. The 1884 Act also sharply separated the two boards by requiring that no member of the managing board simultaneously serve on the supervisory board (§225a). The *Aufsichtsrat* also acquired new responsibilities, in addition to the foundation matters noted above. §225a assigns this board an enhanced oversight role, and clarifies its function in presenting annual reports to the shareholders. The supervisory board also had the right to call shareholder meetings when it thought they were warranted.

The 1884 Act also considerably widens and strengthens the penalties for misbehavior introduced in 1870. Members of the two boards had unlimited, joint liability for violations that threatened the firm's capitalization (§226). The Act also spells out in greater detail the possibility of prison and money fines for corporate officers or founders, who misrepresent matters related to the firm's foundation, misrepresent the firm's condition to the shareholders or the public, or violate many of the other provisions in the 1884 Act.

The 1884 Act, finally, bolsters the rights of individual shareholders or minority blocks of shareholders. The law strengthened individual shareholder's rights to challenge procedures that violated the articles of

association (for example, rules about meetings). Shareholders representing at least 20 percent of the capital could demand compensation for damages caused by the misbehavior of the founders or governing bodies. Shareholders with 10 percent of the capital could invoke §222a, petitioning the courts to investigate irregularities in foundation or operation. Finally, 5 percent of the capital was sufficient to demand a meeting of the shareholders (§237).

The 1884 Act (and earlier efforts) also touched on issues that occupy much of the relevant literatures on corporations in the U.S., the U.K., and other countries. We simply touch on them here, because they played a much smaller role in German discussions. German corporations could and did have multiple classes of shares. The 1884 Act contains language intended to protect the interests of current shareholders from the adverse consequences of introducing a new class of shares, but does not otherwise constrain the firm in this dimension. Detailed empirical research on the subject is lacking, but Meyer (1916) claims that preferred shares (*Vorzugsaktien*) were uncommon. Corporations rarely began life with more than one class of shares, and preferred shares served mostly to recapitalize a failing firm.

The 1870 and 1884 Acts gave corporations great freedom in another dimension, the voting rights attached to shares. Some jurisdictions (including some U.S. states) placed strict controls on voting rights in efforts to protect minority shareholders and to reduce the power of large shareholders. German corporations had to detail voting rules in their articles of association, but were not subject to other rules. Especially after 1884, many individual shareholders allowed a bank to vote as their proxy; in this circumstance, formal voting rules matter much less than the regulations on proxies.

A primary issue for any multi-owner enterprise today is tax treatment. Corporations and similar forms typically pay a tax on the enterprise's income, after which the shareholders pay personal income taxes on their corporate dividends. Partnership forms, on the other hand, usually do not pay the enterprise tax. This way, owners of these enterprises avoid the problem of double taxation. Several individual German states began to levy enterprise taxes on corporations in the last decades of the nineteenth century, but the rates were low and the system often included schemes to avoid double taxation. Tax treatment of enterprise forms first became a primary issue in German company law when the cash-strapped governments of the Weimar era looked to corporate income taxes to solve their fiscal problems.

The Share Partnership after 1870

General incorporation, not surprisingly, made the share partnership less attractive to new ventures. With the 1870 Act, the KGaA lost its basic advantage over the corporation without escaping the rules put into force with the ADHGB. The 1884 Act introduced a new requirement that further disadvantaged the share partnership: the general partners had to subscribe to capital equal to at least 10 percent of the firm's total capital, more if the firm had more than three million Marks total capital (§174a). This rule reflected a fear that a firm could use an impecunious strawman as general partner to limit effective liability, but by requiring a wealthier *Komplementär*, it made the form less attractive to entrepreneurs. The development of other enterprise forms, most especially the GmbH (see below), made the KGaA what it is today, a slightly puzzling anomaly.

The Corporation in the 1897 Commercial Code

The government had initially delayed drafting the corporation law eventually passed in 1884 in part because it wanted to make corporation reform part of a new commercial code. The idea was to introduce a new civil code (*Bürgerliches Gesetzbuch* or BGB) and the commercial code (usually called the *Handelsgesetzbuch*, or HGB) at the same time; but delay in agreement to the new BGB meant that the two came into force together in 1900. The HGB made only modest changes to company law. The most important change, perhaps, relaxed a restriction on corporations that had been a reason for creating the GmbH. German courts had held that corporations could not tie ownership of shares to some other relationship with the firm. For example, the corporation could not require that all share owners also provide a certain input. These restrictions had been attractive to sugar-beet producers during the 1880s. By requiring owners to provide raw sugar-beets to the processing firm, the enterprise guaranteed its raw material, and the local sugar-beet producers who had set up the corporation guaranteed that the firm would not be taken over by non-farmers who had an interest in cutting (for example) prices paid to the beet producers. From its inception, the GmbH could restrict share ownership in this way, but the corporation could not. The 1897 HGB relaxes that limitation for corporations.

5. OTHER ENTERPRISE FORMS

We conclude with brief sketches of three additional enterprise forms.

bergrechtliche Gewerkschaft, bG

The mining company (*bergrechtliche Gewerkschaft*, bG) traces its origins to medieval mining ventures. Prussia formalized this legal form for its territory in 1865, and many mines organized this way. The bG shared many features of the corporation, including limited liability and transferrable shares. The enterprise did not face the same concession requirements as corporations prior to 1870. Neither the 1870 nor the 1884 Corporations Acts affected the bG, so the form remained free of the strictures on share sizes, etc., a fact that led some manufacturing firms to claim they were in fact mines. In its 1865 Prussian incarnation, the bG had to have at least two owners (§94), and the enterprise had the same rights to act as a body assigned to the partnership in the ADHGB (§96). The shares (*Kuxen*) have limited liability (§99), although the *Gewerkschaft* as a body can demand additional contributions from owners to pay for additional investments (§129). Individual owners (*Gewerken* for a bG) do not break up the firm if they sell their *Kuxen*, and cannot force the bG to pay out their share of the enterprise's assets (§100). Engel (1876, p. 8) reports a total of 1112 *Gewerkschaften* in Prussia at that date. Mining firms included another 182 firms organized as corporations and 10 as share partnerships.

Cooperatives

Cooperatives play an unusually important role in the German economy. Although not technically companies (they remain outside the Commercial Code) their legal development took place alongside the developments of company law that form the core of this chapter. The German cooperative movement that emerged in the 1850s reflects long traditions of local organization for self-help.[52] In their first decades they had no special enabling legislation. Associated with Liberal parties then in opposition to the government, cooperatives ran afoul of the (public) law of association, which permitted the authorities to suppress organizations thought harmful to the public good (Brooks and Guinnane (2017)). Changes in the political environment brought cooperatives out from under this shadow, but they faced limitations in enterprise law.

Prussian cooperatives were at best, under the ALR, 'permitted associations.' Just as with early partnerships, cooperatives could not own

[52] The modern associations date to the efforts of Hermann Schulze-Delitzsch (1808–83). The later, more numerous rural cooperatives reflect many efforts, especially F.W. Raiffeisen (1818–88) and Wilhelm Haas (1839–1913).

property, sue or be sued, or contract with others as the cooperative. Cooperatives found it especially difficult to contend with this limitation. Before 1867, cooperative members usually gave their leadership power of attorney (*Bevollmächtigung*) for the cooperative's relevant business (Crüger 1894, p. 394). Establishing the power of attorney required either a notarial act or personal appearance in front of an official, both of which could be costly. Two features of the cooperatives made this legal problem especially serious. Cooperatives often had more than 100 members, and some had several hundred as early as the mid-1860s. Any member's power of attorney could be invalid, and a single invalid power of attorney could force a cooperative to re-initiate a legal action to, for example, recover a debt. In addition, by their nature cooperatives had a constantly-changing membership. Every time someone joined or left a cooperative, the institution had to incur the legal costs mentioned above.

Some cooperative leaders advocated a concession system that would give cooperatives all the rights of a legal person, but Schulze-Delitzsch and other leaders feared this would allow the state to interfere with cooperative affairs. The Prussian 1867 Cooperatives Act took a different approach.[53] Using language identical to the ADHG' partnership rules, the 1867 cooperatives law offered the enterprises a way to achieve what they needed, the right to act in their own name, without going the full route of demanding corporate rights.[54] The 1867 Act created a public registry of cooperatives that paralleled the register of firms (*Handelsregister*) used to track business enterprises.

The 1889 Cooperatives Act introduced two further changes of interest to enterprise law more generally: mandatory external audits and limited liability. The mandatory auditing provision marks the first time any German enterprise form faced such a requirement (Guinnane 2003). From their earliest days cooperative leaders promoted regional associations, most of which encouraged a sort of informal audit of member cooperatives (Beham 1940, pp. 16–18). Article 51 of the 1889 Act required that every cooperative be audited at least once every other year, and empowered these regional cooperative associations to organize the audits.[55]

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[53] Schulze-Delitzsch, then a member of the Prussian Chamber of Deputies, first advanced a draft bill in 1863. The substantially different 1867 Prussian law was extended virtually unchanged to the rest of the North German Confederation in 1868 and eventually to the rest of the Reich (Joël 1890, p. 421).

[54] Compare §111 ADHGB to §10 1867 Prussian Cooperatives Act.

[55] Prior to the 1889 Act, some few cooperatives had organized themselves as corporations, presumably to enjoy limited liability. Goldschmidt (1882, p. 28

Schulze-Delitzsch, Raiffeisen, and other cooperative leaders generally stressed the practical usefulness of unlimited liability for cooperatives. But lurid stories of insolvencies were a staple of critical commentary about German cooperatives. For example, the 1875 failure of a Magdeburg cooperative required levies on members that led to over 400 local foreclosures (Schneider 1885, pp. 187–8). After the 1889 Act, German cooperatives could choose from three different liability rules. They could have unlimited liability, as before; limited liability, under rules similar to a corporation; or a new, third, new form, called unlimited contributory liability (*unbeschränkte Nachschusspflicht*).[56] Limited liability at first remained rare outside selected parts of the cooperative group. Unlimited-liability cooperatives typically had little paid-in capital; often credit institutions, they maintained high leverage by implicitly pledging the members' personal assets as security. This balance-sheet structure did not serve well the needs of other cooperatives (such as creameries and marketing cooperatives) that needed paid-in capital to pay for buildings and equipment. Consumer cooperatives adopted limited liability for a different reason: it made little sense for a household to expose itself to financial ruin so it could purchase lower-cost groceries.

The most compelling argument against unlimited liability for cooperatives was that they were, in fact, cooperatives. Most partners in an OHG devoted themselves principally or entirely to the business at hand. Cooperatives, on the other hand, existed to provide services to individuals whose livelihood came from another enterprise. The cooperative's large and changing membership also raised difficulties for potential creditors who wanted to know how much backing member assets really offered; a cooperative with unlimited liability offers, implicitly, its members' property as collateral, and the value of that property might be difficult for outsiders to verify.[57]

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note 170) suggests that 25 former credit cooperatives were corporations as of 1881. After 1884 this strategy was presumably less attractive, although some sources claim that some cooperatives preferred the corporate form to evade the 1889 Act's auditing requirements.

[56] Few cooperatives organized with *unbeschränkte Nachschusspflicht.* This liability form is best thought of as a form of unlimited liability that restricts the right of creditors to sue cooperative members, as opposed to the cooperative itself. This form reflected the suggestions of Levin Goldschmidt, who thought the problem was the way cooperative law dealt with unlimited liability rather than unlimited liability *per se*.

[57] Rural cooperatives had early on developed 'Centrals,' regional institutions that provided services not possible for small institutions run by non-professional staff. Prior to 1889, most rural Centrals were arguably illegal if registered under

The GmbH

In 1892, Germany created a new legal form for business enterprises, the *Gesellschaft mit beschränkter Haftung* (company with limited liability; hereafter GmbH). One can locate musings about the idea of a new enterprise form earlier, but the first well-known suggestion appears in Ludolf Parisius (1876)'s analysis of German cooperative law. Parisius, a major figure in the cooperative movement, advocated allowing any firm that wanted to organize as the *bergrechtliche Gewerkschaft* spelled-out in Prussia's 1865 mining Act. In another approach, Oechelhäuser proposed allowing a second type of partnership (OHG), one where all owners had limited liability. The 1892 Act adheres more closely to the core idea of the bG, allowing the new enterprise form to combine elements of the partnership with elements of the corporation. Although the GmbH caught on slowly at first, by the 1930s it was very popular, and today it is the overwhelming favorite form for a wide range of enterprises.

A firm organized under the 1892 GmbH statue constitutes a legal person in which all owners have limited liability. The firm had to have an authorized capital (*Stammkapital*) of at least 20,000 Marks, of which 5000 Marks had to be paid in at the firm's creation.[58] While the GmbH's rules differ in subtle ways, some reflect the logic applied to corporations and others are more like the partnership. The law required a separation between ownership and management, as in the corporation. As expected, most GmbHs were run by someone who owned part of the firm. The firm's articles of association could not, however, require that a specific person always be manager (*Geschäftsführer*). The law required (§38) that the manager be freely dismissible. As in corporations, ownership stakes had to be alienable and heritable. The articles of association could limit transferability in several ways, for example, by requiring agreement of the other owners if a share was to be sold to someone not currently an owner. Other provisions make the GmbH more similar to a partnership.

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the 1867 Act. Without natural persons as members, they could not draw their *Aufsichtsrat* from the membership, as required by law. And the dual level of unlimited liability made them dangerous for the members of the local co-operatives. The 1889 Act's limited-liability provisions made Centrals more workable. See Guinnane (1997).

[58] Owners have joint and several liability for any part of the *Stammkapital* that was not paid in. Per-capita GDP in Germany in 1892 was 470 Marks, so the GmbH's minimum capitalization was equal to 42 times the per-capita income (Hoffman Table 248, p. 825 and Table 1, p. 172), and its minimum paid-in capital was more than 10 times per-capita income.

Because the GmbH is a contract among *specific* persons, just like a partnership, its equity claims are quotas (*Anteile*) rather than shares (*Aktien*). Transferring ownership from one person to another required a notarial contract. The GmbH cannot list its quotas on equity markets, making them less liquid than corporate shares. This reflected an effort to tie the owners more closely to the firm than was the case with a corporation. This, the drafters thought, could offset some of the perceived dangers of limited liability in a small firm. Some of the *Kapitalschutz* rules applied to corporations also apply to the GmbH; the firm cannot, for example, pay dividends that would reduce its capital stock below the figure specified in the articles of association.

For most other matters, the statute states a default rule. For example, while GmbHs could have either or both of the managerial committees required for corporations (the management committee or *Vorstand* that ran the firm, and the supervision board mentioned earlier), neither was required. This and other provisions reduced the fixed costs of establishing and operating the firm, making the GmbH more suitable to enterprises too small to afford the requirements of the 1884 corporation.

The GmbH law also allows the articles of association to require that owners have a relationship with the firm that goes beyond contributing capital; one owner might be required to provide services, and another might be required to provide particular inputs. As a consequence, the firm could also list conditions under which minority shareholders can be forced to sell their shares. The underlying notion is that some events may make the continued association of some shareholders intolerable for the firm, and the firm must have the right to be rid of them. Such provisions were forbidden for the corporation until the HGB revision of 1897.

Why would the government agree to create this enterprise form? Calls for a new enterprise form came from several quarters and reflected three broad sets of concerns. One persistent view argued that existing German company law held back the growth of the German economy because it did not reflect the needs of the day. The 1884 Act intensified these claims, but was not their origin. Many used the metaphor of a gap (*Lücke*) in the menu of legal forms to argue for something inbetween the partnership and the corporation. The motivation (*Begründung)* for the 1892 Act lists slightly ludicrous examples of what firms would do to evade the constraints of the 1884 Corporations Act. The strict rules on in-kind capital contributions made it difficult for operating businesses to re-form as corporations, or for owners of patents and other non-tangible assets to use them as capital contributions. More generally, the *Kapital-schutz* provisions of the 1884 Act meant that such enterprises worked best if much larger than most firms that would become GmbHs. A

different problem reflects the financial reporting requirements written into the 1884 law. Some German entrepreneurs viewed mandatory publicity as requiring firms to reveal information that their competitors, especially foreign competitors, could immediately put to use. The 1884 Act might have succeeded in making corporations safer, but, according to Öchelhauser and other critics, deterred the formation of many valuable firms.[59]

A second argument reflects discussions of firms in Germany's new colonies. From the outset most Germans involved with colonial policy intended to make German colonies at least pay for themselves, a demand that put pressure on colonies to develop commercially. The 1884 law put German colonial firms in an awkward position: they needed to raise capital on German capital markets, but were usually not large enough to justify the reformed corporate form. A partnership in which some owners were in Germany and others in Africa (for example) posed its own problems. In the 1880s a number of firms took the unusual step of organizing themselves under the ALR, which still had corporations by *Oktroi*. But neither the Prussian government nor business saw this as a good solution, and in 1888, as part of a more general law governing German colonies, the Reich adopted measures that allowed the upper federal chamber (the *Bundesrat*) to permit corporations in German colonial territories that would not have to adhere to the 1884 Reich Corporations Act.

A third set of arguments reflects perceptions of how British entrepreneurs were using the (U.K.) 1862 Companies Act to create corporations not possible in Germany. Even before Britain's 1897 *Salomon* case, Germans complained loudly that the 1862 Companies Act allowed British firms to establish corporations that were really a single entrepreneur and six straw men. The 1862 Act allowed general incorporation without a minimum share value and without many of the expensive formalities required of German corporations. British firms with share values of £1 were common, and companies with share value of 1s. (that is, *one* Mark) were not unknown. The popularity of the corporate form in Britain lent strength to the case; in 1900, for example, 4849 firms registered as new corporations in the U.K, compared to 84 in Prussia.[60]

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[59] Thiessen (2009, E) notes the enterprise forms are often called 'legal clothing' (*Rechtskleid*) in which case the 1884 Act required the use of a corset.

[60] The U.K. figure is from Guinnane et al (2007, p. 19). Thiessen (2006) stresses the example of British companies on German thinking about limited-liability firms.

The GmbH exercised considerable influence on other countries. Some, like Austria, enacted nearly identical forms. Others (like France) created forms that resemble the GmbH in many respects, but deviate in important ways. Discussions of the French SARL show that its creators were acutely aware of how GmbHs worked, not least because of the many GmbHs operating in Alsace and Lorraine when France took the two provinces back in 1919. In other countries, such as Spain, the GmbH had its admirers, and while the legal form eventually created might differ considerable from the GmbH, the German form was a frequent touchstone in the discussion.

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8. German corporate law in the 20th century

Thilo Kuntz[1]

1. INTRODUCTION

German corporate law in the 20th century was marked by a steady flow of reforms moulding and shaping the corporation. Having started at the outset of the century with a corporate governance model revolving around shareholder power (at least according to the law in the books), the reform of 1937 established a shift to a board-centered structure, which prevails until today (section 6). Adhering to the structure set nearly 30 years' earlier, another reform in 1965 mainly readjusted several details and sharpened the model's features, with two exceptions: it contained a section on *Konzernrecht*, the law of corporate groups, and massively restricted the freedom of contract in corporate law by disallowing deviations from the *Aktiengesetz* in the corporate charter (section 8). Codetermination laws in 1951, 1952 and 1976 established board-level employee participation (sections 7 and 9). Beyond these and other, smaller, reforms, German corporate law was part of broader political developments in Germany – the agony of the Weimar Republic, the rise and fall of the Third Reich, democratization and Europeanization. This chapter aims at providing a longitudinal view of German corporate law. For the years 1945–1990, it is a history of corporate law in West Germany. Readers will, for the most part, not find an explanation of the specific rules governing board members' duties, capital maintenance or other details. Instead, they will find out about how the two-tier board structure evolved and why it is still in place today, why German corporate law abolished the shareholder-centric model of old and which ideas lie behind the concept of board-level codetermination so foreign to many non-Germans (for a detailed overview of legislation on corporate law Fleckner 2007).

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Before going into detail, a caveat is in order: this chapter solely deals with the *Aktiengesellschaft* (on the *Aktiengesellschaft* in the German system of company law Henssler and Wiedemann 2007). It does not provide any information on the *Gesellschaft mit beschränkter Haftung* or *GmbH*, governed by the *Gesetz betreffend die Gesellschaften mit beschränkter Haftung (GmbHG)* (of 20 April 1892, in force since 1 January 1900). The *GmbH* is a type of close corporation (for a short introduction to German company law in general see Fleischer 2015). Its shares cannot be publicly traded. Other than in non-German corporate laws, the change from 'close' to 'public' corporation is not a function of the number of stockholders, turnover or other factors. Whether the corporate form is an *Aktiengesellschaft* or a *GmbH* depends on whether the founders choose to register an *Aktiengesellschaft* or a *GmbH*. The *GmbH* is also not comparable to a statutory close corporation, e.g., the Delaware statutory close corporation, as there is no limit as to the number of shareholders. In fact, several major German companies are organized as a *GmbH* (e.g., Robert Bosch GmbH with a group-wide turnover of more than EUR 70 billion in 2015). Three main reasons other than the limitations in word-count justify this sole focus on the *Aktiengesellschaft*: first, as the *Aktiengesellschaft* encompasses the close corporation with respect to the realities of the corporate form, this strategy does not lead to any significant gap in substance. Second, as the scholarly debate from a comparative point of view focuses on the public corporation, this author assumes the *Aktiengesellschaft* to be the most interesting corporate form in Germany. Third, the *GmbH* retained its core structure throughout the 20th century, a reform in 1980 changed mainly details. Readers interested in the essential features of the *GmbH* may thus rely on Chapter 7.

2. GERMAN CORPORATE LAW AT THE BEGINNING OF THE 20TH CENTURY

The 19th century ended with a regulatory concept centering on shareholders and the shareholders' assembly (*Generalversammlung*, today *Hauptversammlung*). Ever since the ADHGB 1861 (see Chapter 7), shareholders were allowed to issue instructions and restrict the executive board's (*Verwaltungsrat*, later *Vorstand*) decision rights according to their will and whim. The shareholders' assembly was the supreme authority within the *Aktiengesellschaft* until the 1937 reform (Fleischer 2007; on the 1937 reform see below). It had the right to 'adopt resolutions and make decisions in all matters touching at the essence of the corporation'

(Begründung 1883). The reforms of 1884 (*Zweite Aktienrechtsnovelle*) laid the foundations of the German corporation's basic corporate governance structure by establishing a mandatory supervisory board (*Aufsichtsrat*) in addition to the executive board and the shareholders' assembly. What had been left open was, however, the question of a clear division of power. Whereas the law in the books expressly stated that it was the executive board's task to represent the corporation, the law in action more often than not provided the supervisory board with executive powers such that no real change had been achieved (Lutter 2007; Lieder 2006; for empirical material see Flechtheim, Wolff and Schmulewitz 1929). As early as 1884 one of the leading scholars of the time pointed out (as a positive feature of the reforms) that the *Aufsichtsrat* could be converted from supervisory board to executive board in the articles of association (Goldschmidt 1884). It was thus possible to rearrange basic corporate governance features by contract and allow individuals to wield disproportionate decision power. Blockholders could avail themselves of a seat on the supervisory board. If the supervisory board had been endowed with a certain surplus of decision rights, essentially altering its functions towards an additional executive board, blockholders could reign supreme. Moreover, private banks took up seats in the *Aufsichtsrat* in order to secure for themselves a position of influence (see Hopt 1979), a problem which would last as a feature of 'Germany, Inc.'s' corporate network until modern times (see Windolf 2014 and section 10 below). In sum, the supervisory board could be put under two hats. It had not yet been thoroughly set into place as a board with mainly supervisory functions. This did not change with the enactment of the *Handelsgesetzbuch* of 1897 in 1900. Beyond this 'issue of the supervisory board' (*Aufsichtsratsfrage*), i.e., the question about the utility and necessity of a supervisory board (see, e.g., Passow 1909; Riesser 1903; in broader perspective Lieder 2006) and the general problem of distributing authority along a cogent concept of corporate governance and corporate groups increasingly became the object of attraction. Background was, inter alia, the accumulation of shares by corporations. Corporations invested heavily in shares (Tilly 1973), thus building groups or at least holdings of large blocks of stock (for details Dettling 1997; Hommelhoff 1982; Nörr 1986; Spindler 1993). Critics of this kind of corporate group building were in the minority, however (see Altmeppen 2007; Dettling 1997; for further details on the law regulating corporate groups see section 8).

3. 1914–24: FROM DEBATE OVER REFORM TO MINIMUM CAPITAL

During the First World War, discussion came to a halt. Sparse legislation in the corporate law area served war aims and, with the exception of codetermination legislation in 1916 (section 7), did not set new developments in motion (for a concise overview see Assmann 1992). This changed in the Weimar Republic. The 1920s were a period of debate and consolidation with regard to corporate law. Corporate law was argued about against the backdrop of economic developments in the Weimar Republic: after inflation had reached its peak in 1923 (the 'hyperinflation') and after the German default in reparation payments, 1924 saw a currency reform with the introduction of the *Reichsmark* and the Dawes Plan on reparation payments, replacing the 1921 London Schedule of Payments (see generally Winkler 2005).

Although the corporate law of the *Handelsgesetzbuch* was left unchanged in its basic structures until a partial reform in 1931 (section 5), 1923 saw the introduction of what is today regarded as one of the (in)famous peculiarities of German corporate law: the minimum capital requirement (on the history of legal capital requirements in German corporate law, see Bayer 2007; Thiessen 2009). There had been a form of indirect regulation of the amount of capital necessary to found a corporation (five members each taking at least a register share for 200 marks or a bearer share for 1,000 marks, see Bayer 2007; Thiessen 2009). An explicit minimum capital requirement existed, however, for the *GmbH*, introduced in 1892 (see Thiessen 2009). The idea was to limit the number of 'incorporations either minuscule or not well-funded' and to protect creditors (*Begründung Entwurf GmbHG* 1891; see Thiessen 2009). By enacting the law on minimum capital for *Aktiengesellschaften* in May 1923 (*Gesetz über den Mindestbetrag des Grundkapitals von Aktiengesellschaften und Kommanditgesellschaften*), the *Aktiengesellschaft* was obliged to have a minimum capital of five million marks. The official explanation issued with the draft gave two reasons (*Begründung zum Entwurf* 1923): the number of 'minuscule' incorporations, or, as the official explanation put it, a high tide of filings for 'dwarf corporations' (*Zwerggesellschaften*) that registration offices were drowning in. Additionally, there had been an 'undesirable preference' to incorporate in the form of an *Aktiengesellschaft* instead of using the *GmbH*. Still, the question remains: why now? What was the background against which the legislator felt compelled to act? On closer inspection, three aspects stand out. First, in 1922 the *GmbH*

minimum capital was raised significantly in view of inflation, thus provoking founders to opt for the *Aktiengesellschaft* as alternative. This alone, however, lacks sufficient explanatory power as the minimum capital traditionally was not considered to be a significant obstacle to incorporation (see Thiessen 2006; Thiessen 2009). Second, tax loopholes provided incentives to use the *Aktiengesellschaft* (see *Begründung zum Entwurf* 1923). Third, inflation, which had by now evolved into hyperinflation, led people to buy shares and found corporations because this allowed them – at least to a certain extent – to counter the massive and rapid decline in the value of money. This was true even for those who traditionally had not been prone to 'speculation' (see Thiessen 2006 on the 'housewife'). Thus, hyperinflation did not cause a disruption in the way some economists assert (Perotti and von Thadden 2006), at least not immediately. On the contrary: it even drove groups into stock investments who under non-inflationary conditions would not have bought shares at all. Even years after the currency reform in 1924, the German stock market thrived (Burhop, Chambers and Cheffins 2015; Hardach 1995). In sum, in 1923, the time was ripe for legislation because too many investors had opted for a corporate form deemed not to be beyond doubt. This idea resonated with the reformers in 1937 (see section 6 below). The minimum capital requirement was then amended by the ordinance regarding the preparation of balance sheets in *Goldmark*, the *Verordnung über Goldbilanzen* of December 1923, sometimes wrongly regarded as the origin of the minimum capital requirement for *Aktiengesellschaften* (e.g., Bähr 2006; Bayer 2007; even the government's official reasoning concerning the draft of the 1965 reform). This ordinance was a follow-up to the currency reforms (see above) and aimed at clearing the balance sheets of the 'phantastic mosaic' of numbers expressed in the old, highly inflated currency (Schlegelberger 1925).

4. THE GOLDEN YEARS 1924–29: FURTHER DEBATE

The phase of relative political stability ensuing after 1924 was accompanied by tightening economic conditions for enterprise financing. In order to secure monetary stability, the *Reichsbank* was adamant about controlling the credit volume handed out by commercial banks and it declared a *Kreditstopp* (see Bosch 1927; Schnabel 2004, also for exceptions from the rule). Because of the resulting shortage of available German sources for financing business, German industry had to look for foreign capital. Foreign investors, the majority of them US-based, provided debt financing and invested directly, e.g., the Ford Motor Company

(production facilities in Berlin 1925 and Cologne 1929). They took over German targets and entered the German market (General Motors bought the Adam Opel Aktiengesellschaft in 1929; see generally Machlup 1932; Link 1970). There was a massive US-dollar influx to Germany, mainly based on bonds, but with significant other investments (shares and direct investments) as well (Dunn 1926; Link 1970; see also Pohl 1983; Schnabel 2004). At the same time, the number of corporate groups rose steadily (see Spindler 1993; for the banking sector Schnabel 2004). The increase in consolidation and group-building often was not part of a clear business strategy, but the result of 'more or less random acquisitions' (Pohl 1983). From the management's point of view, these developments gave reason to install protective measures (see Spindler 2007). Incumbents sought to issue shares with multiple voting rights (*Mehrstimmrechtsaktien*), dual class structures and *Vorratsaktien*. The latter type was a regular share issued without stockholders' preemptive rights and bought by banks which would hold them on behalf of the corporation and thus at management's disposal. In addition, banks would use their proxy voting power for shares in their custody accounts (*Depotstimmrecht*) heavily in management's interests (Hartmann 1924/25). Additionally, corporations, led by management, engaged in transactions with the corporation's own shares, a phenomenon viewed as a corporate governance problem (see Cahn 2007).

In view of these developments, many called for reform. Two *Deutsche Juristentage* in 1924 and 1926, until this day one of the most important fora for the discussion of legal issues in Germany, dealt with the question of whether German corporate law should be remade after the model of English and US-American corporate law (see Spindler 2007). The experts' opinions given at the *Juristentag* 1926 expressed grave concern about the then current state of German corporate law. On the one hand, they strongly advocated more flexibility, e.g., with respect to raising capital, and better means of shareholder protection on the other (Lehmann 1926; Pinner 1927). One expert referred to Germany's role as money-taking, thus necessitating a corporate law being attractive enough to draw foreign investments (Lehmann 1926). Many pundits held shares with multiple voting rights to be a severe problem, as they typically were used in order to protect the incumbent management (e.g., Horrwitz 1926). However, several experts regarded these shares and the *Vorratsaktie* with more clemency by pointing out reasons for keeping them (Lehmann 1926; Pinner 1927): protection of minority shareholders and even protection of the German economy against *Überfremdung*, i.e., too many German corporations being taken over by foreign investors, and, regarding the wave of consolidation, securing a 'stable' management. In

the end, only two questions remained: how to restrict abuses of such shares and the introduction of authorized capital in order to cope with the problems of the *Vorratsaktie* (Lehmann 1926; Pinner 1927). The experts agreed on the need for a better supervision of management, but, however, disagreed on how to accomplish that. Whereas some wanted to strengthen and at the same time restrict the *Aufsichtsrat*'s role to its supervisory task (Lehmann 1926), others argued in favour of the practice prevalent at the time and, relying on English law, called for auditors (Pinner 1927). Two working groups, one commissioned by the *Deutsche Juristentag* of 1926, the other the *Enquête-Ausschuß*, both delivering reports on the current state of corporate law in 1928, failed to see much need for reform (see Schubert 1986a). This resonated with the general mood opposing fundamental changes (see Assmann 1992; Wiethölter 1961).

The period of reflection and debate ended with the *Reich*'s department of justice (*Reichsjustizministerium*) beginning to collect material on foreign corporate law and to prepare a reform proposal in 1927 (see Schubert 1986a). The department's baseline was that there was no need for a general revision of corporate law. Rather, it regarded the issue as the improvement of control and transparency with respect to the growing power of the board. In 1930, the department published a draft, the '*Entwurf eines Gesetzes über Aktiengesellschaften und Kommanditgesellschaften auf Aktien*' (in German parlance: 'E I' for *Entwurf I*). In terms of substance, this draft was not revolutionary and did not pretend to be. The draft's architects sought a middle way between the extremes. They judged reform to be necessary but only by building on and strengthening existing mechanisms, not through fundamental changes in the corporate governance system (see Schubert 1986a). There were no substantial revisions with respect to the supervisory board's tasks. To counter practices of the executive board deemed problematic, loans to members of the executive board were made subject to prior supervisory board approval. Moreover, the draft introduced better transparency rules, strengthened shareholders' information rights and called for mandatory balance-sheet auditing by independent auditors. Whereas it prohibited *Vorratsaktien*, it did not provide for any real changes regarding shares with multiple voting rights and banks' proxy voting practices. In addition, the draft allowed for much more flexible ways to raise capital. In July 1931, the 1930 draft was revised and submitted to the *Reichskanzleramt* (so-called 'E II', meaning '*Entwurf II*', see Schubert 1986a). There was no sense of urgency. This, however, was about to change abruptly.

5. THE END OF WEIMAR, 1929–33: ECONOMIC DOWNTURN, A PARTIAL REFORM THROUGH THE EMERGENCY ORDINANCE OF 1931 AND ANOTHER DRAFT

The department of justice's preparatory work and the debate in government circles concerning corporate law reform was overtaken by the economic developments. After the so-called 'golden twenties' (for a critical review Knortz 2010), the economic conditions worsened significantly. In August 1929, the Frankfurter Allgemeine Versicherungs-AG (FAVAG), the second largest German insurance company, collapsed (see Modert 2004). The stock market crash in 1929 led to a massive downturn, not only resulting in a crisis of industry, but in a severe banking crisis as well (see Hardach 1995; James 1986). In November and December 1929 alone more than 100 private banks went into insolvency (Landsburgh 1930). In many cases, there were at least allegations of balance sheet manipulation and other fraudulent practices (for the FAVAG Modert 2004). The downward spiral spun ever faster following the spectacular and highly publicized breakdown of 'Nordwolle', Europe's biggest producer of textiles, which in turn caused the bankruptcy of one of the biggest German banks, Darmstädter und Nationalbank (Danat), in July 1931 (on the importance and interconnection of the Danat bankruptcy with regard to other factors causing the banking crisis Hardach 1995; Schnabel 2004). Due to the ensuing German twin crisis in the banking sector (a currency crisis in the form of a run on the *Reichsmark* and a bank run, see Schnabel 2004), a huge collapse of German banks followed, resulting in massive government intervention. By 1932, 91 per cent of the Dresdner Bank, 70 per cent of Commerzbank and 35 per cent of the Deutsche Bank were held by the government (Born 1967). As a reaction to the Danat bankruptcy, official trading on German stock exchanges was interrupted from 13 July 1931 until 12 April 1932, with some exemptions for spot dealings (see Beer 1999 for details). Even before this interruption, average daily trades had fallen by 20 per cent in July 1931 compared with June 1931 (Beer 1999). Suddenly, the regulatory environment had turned into a thunderstorm. What had begun in the early second half of the 1920s as a careful debate about the necessities and subtleties of corporate law all at once changed into a race for regulation.

At the beginning of August 1931, the members of the (*Reich*'s Chancellor) Brüning government still argued against using Article 48 of

the *Reich*'s constitution, allowing the *Reichs*' President to enact emergency decrees (*Notverordnung*), i.e., to legislate without a decision by parliament (see protocol of 5 August 1931, R 43 I/1451, 61–74, printed in Koops 1982). This was in line with the general mood (see Schubert 1987). Just one month later, in September 1931, views had changed and the government opted for a limited corporate law reform through a *Notverordnung* (protocol of 14 September 1931, R 43 I/1452, 269–274, printed in Koops 1982), enacted on 19 September 1931, published 21 September 1931 (for an overview of the government's internal debate: Thiessen 2009). This *Notverordnung* contained partial regulation only (see Engelke and Maltschew 2007). Whereas the law concerning share buy-backs and loan agreements between the members of the *Vorstand* and the corporation was tightened and a couple of transparency rules were introduced, the *Notverordnung* did not change banks' proxy voting rights nor the law concerning shares with multiple voting rights. In the summer before the enactment of the *Notverordnung*, the department of justice had drafted yet another reform proposal. This proposal was published only after the *Notverordnung* had entered into force and served as a blueprint for further discussion.

In 1932, the *vorläufiger Reichswirtschaftsrat*, an institution created on the basis of the *Weimar* constitution with advisory function for socio-political and politico-economic legislation (on the *vorläufiger Reichswirtschaftsrat* cf. Lilla 2012), commissioned a committee on corporate law (*aktienrechtlicher Arbeitsausschuss*) to evaluate the new draft (see Schubert 1986a). The draft and the report delivered by the committee anticipated many changes of the reform of 1937 (see Hommelhoff 1987). However, because the Nazi government abolished the *vorläufiger Reichswirtschaftsrat* in 1934, the work done by its committee was no longer mentioned as a source of inspiration.

Seen as a whole, the years from the beginning of the 20th century up to 1933 experienced no major reforms of corporate law. Nevertheless, what proved to be very important for the years to come was the intense debate. It had brought several issues into the limelight which needed to be addressed in the future, such as the *Aufsichtsratsfrage* and the shareholders' authority. The positions, however, were divided between those who wanted to hold on to the reality of corporate governance and keep the boards strong and shareholders weak and those who urged for a clearer division of power, namely strengthened shareholder decision rights and a supervisory board with better supervisory powers and limited rights to act alongside the executive board. Not all of those who wanted to limit shareholder rights stood on the same ground, however. Whereas many argued from an efficiency-oriented perspective, others stressed an

argument that should prove momentous (for a concise overview Drescher 1932): the theory of the *Unternehmen an sich*, the corporation as a 'thing in itself'.

In 1917, Walther Rathenau, a Jewish businessman, outspoken liberal and member of the German government in 1921/1922, murdered by a right-wing terrorist group in 1922, published *Vom Aktienwesen*, commonly considered as the seminal work (Rathenau 1917). In this small book, Rathenau argued against the idea of 'shareholder democracy' and extended shareholder rights. The corporation should be integrated into the 'economy of the whole' (*Wirtschaft der Gesamtheit*) and steeped in the spirit of responsibility for the common good and the public weal (*Durchdringung mit dem Geiste der Gemeinverantwortlichkeit und des Staatswohls*). Although several authors opposed this line of thought (e.g., Haussmann 1931/1932), they could not stop Rathenau's approach from influencing legislation and (mis-)use in later years under the Nazis as well as later in modern Germany (see below; on the debate Riechers 1996; Spindler 2007; on earlier authors arguing in the same vein as Rathenau see Fleckner 2007; as an aside, compare the similar perspective of important German economists such as Schmoller and the school of the *Nationalökonomie*, see Barkai 1988 and, critically, Hesse 2006). In the course of the debate about corporate law reform, the participants, scholars, practitioners and 'the state', had garnered an impressive quantity of material in terms of comparative law scholarship. Not only the expert opinions written for the *Juristentage*, but the department of justice and others as well had subjected the German corporate law to a detailed comparison with English and US-American corporate law (see von Hein 2008). This groundwork would prove to be influential during the preparations for the corporate law reform of the year 1937.

6. CORPORATE LAW 1933–45: STATE INTERFERENCE AND THE REFORM OF 1937 – FROM SHAREHOLDER POWER TO BOARD AUTHORITY

The 1937 reform represents a major turn in German corporate law. It contained many features still formative for German corporate law today, such as a strict separation of power between *Vorstand*, *Aufsichtsrat* and shareholders, combined with a strengthened board system and limited shareholder rights. The shift in paradigm found expression not only in substance, but in form as well. With the 1937 reform, corporate law was no longer part of the *Handelsgesetzbuch*, but was accoutered in its own

cloth, the *Aktiengesetz*. The new law reflected two lines of thought, pointed out by the author of a widely-used introduction to the new *Aktiengesetz* (Klausing 1937; on Klausing see Diestelkamp 2000): on the one hand, the *Aktiengesellschaft* as a phenomenon known internationally as a product of and within capitalist society with common problems (creditor and minority shareholder protection, management structure, etc.); on the other hand, in his mind, an institution bound to special questions (*Sonderfragen*) of 'national character'.

The preparatory work was done by a committee of the *Akademie für Deutsches Recht*, an institute created in 1933 with the purpose of laying the foundations for an overhaul of German law according to the Nazi ideology (see Pinichot 1981), worked on corporate law reform (see Schubert 1986b; on the committee's reports Bayer and Engelke 2007). It delivered reports which were highly influential with respect to the reform. A closer look at the reports on the discussions during sessions of the committee for corporate law and public statements by members of the Nazi party reveals that things had not been easy. In fact, a number of fairly high-ranking officials wanted to see the *Aktiengesellschaft* abolished or at least radically transformed in accord with Nazi ideology. Hitler himself had qualified the *Aktiengesellschaft* as a 'serious symptom of economic decline' ('*schwere wirtschaftliche Verfallerscheinung*') leading to the 'slow withdrawal of personal ownership rights' and 'the passing of the ownership of the economy as a whole to corporations' (Hitler 1925). There was, however, no clear idea of what a proper Nazi *Aktiengesellschaft* should look like. Policies at the time (i.e., 1933/1934) were based on a crude amalgamation of emphasis on the *Führerprinzip*, socialist elements, abolishment of 'effortless income', differentiation between money-grabbing ('*raffenden*') and productive ('*schaffenden*') economic activities, and, generally, the belief in strong state interference (still seminal: Barkai 1988; for a more recent overview see Hesse 2006). Wilhelm Keppler, economic advisor of the NSDAP since December 1931, founder of the 'Keppler Circle', Reich Commissioner for Economic Affairs from July 1933 (on Keppler see Riedel 1977), took part in sessions of the committee for corporate law. He spoke in favour of the emergence of a *Führer*-class in the economy (see *Aktienrechtsausschuss*, report on the session of February 10, 1934). Human performance should be estimated higher than ownership of 'capital'. Furthermore, Keppler argued in favour of finally abolishing shareholder rights altogether. The shareholders' assembly (*Generalversammlung*) was to be reduced to a vote of confidence with regard to the executive board. This proposal, however, was met with 'general silence' (*allgemeines Schweigen*), as the

discussion report duly noted (*Aktienrechtsausschuss*, report on the session of 10 February 1934).

In the end, the legislator wanted to hold on to the *Aktiengesellschaft* as a 'proper corporation' ('*ausgesprochene Kapitalgesellschaft*') since the modern economy could not continue without it. The *Aktiengesellschaft*'s existence was grounded in the need for an accumulation of capital provided by as many sources as possible and the distribution of risk on as many shoulders as possible (Kißkalt 1934). This did not mean, however, that the *Aktiengesellschaft* was regarded as being inherently beneficial. Members of the committee for corporate law and department of justice officials agreed on two major issues: the need for strengthening the *Führerprinzip* on the one hand and reducing anonymity of share ownership on the other (see Kißkalt 1934; Klausing 1937). The reform aimed at 'personalizing' (*Verpersönlichung*) the *Aktiengesellschaft* (Bayer and Engelke 2007). The possibility of buying shares anonymously via a stock exchange was considered to be dangerous as buyers 'without tradition' (*traditionslose Neuerwerber*) and an 'anonymous and irresponsible' majority were thus able to gain control over the corporation with nothing on their minds other than speculation, contrary to the corporation's interests as well as to the principles of national-socialist management.

A first draft in 1935, written by the department of justice, building on the Weimar reform proposals and heavily influenced by the committee's work, followed both paths (Schubert 1986b). As a baseline, it followed the idea of the corporation as a 'thing in itself' (*Unternehmen an sich*, see section 5 above). The emphasis on the corporation's integration into the 'common good' and the *Volkswohl* fitted well into the Nazi ideology of the *Volksgemeinschaft* (see Riechers 1996). It would, however, be a misconception to view the draft (or the 1937 reform) just as a brainchild of Nazi ideology in this regard. Franz Schlegelberger, second in the department of justice's hierarchy (and later acting head of the department) had been a main actor on the government's side during the Weimar discussion and proponent of the *Unternehmen an sich*. As one of the persons responsible for the 1930 reform draft, he followed his own lead in taking over basic concepts and reframing them according to the new policy framework (Bähr 2006; on Schlegelberger see Nathans 1990). In substance with respect to corporate governance, the 1935 draft differed considerably from the Weimar drafts: the executive board was to be significantly strengthened, with the flipside of weakening the shareholders' position. The executive board held voting rights amounting to a fifth of all voting rights, prepared the balance-sheet statement, had the right to decide on the distribution of profits; multiple voting rights per share were to be abolished, banks' proxy voting rights curtailed. Should

only one shareholder be left, a court principally had to decree the corporation's dissolution. A minimum capital requirement of 500,000 *Reichsmark* should force founders to use the *Aktiengesellschaft* for large enterprises only. Two contributions were important for the further discussion: in August 1935, Schlegelberger delivered a speech which attracted a lot of attention (on Schlegelberger see above). After briefly commenting on the necessity of having *Aktiengesellschaften*, he spoke in favour of empowering the executive board. In the course of urging a substantial cut back in shareholder rights, he coined the (in-)famous phrase that as a consequence of the new law the shareholders' assembly would be a 'deposed king' (*abgesetzter König*), with only those issues left to vote on expressly provided for in the law or in the articles of association (Schlegelberger 1935). With the exception of a few details, Schlegelberger supported the draft. The second important contribution was the speech of Hjalmar Schacht, president of the *Reichsbank* and Secretary of Commerce (*Reichswirtschaftsminister*) at the same time in 1935, which rang quite a different bell (on Schacht see Kopper 2006). He underlined the importance of capitalist institutions and the relevance of the *Aktiengesellschaft* as a capitalist enterprise. Schacht pleaded against impeding the marketability and liquidity of shares as well as against disenfranchising the shareholders and for accountability of the executive board with respect to shareholders. Whereas he considered the *Führer*-idea to be vital, he held it to be an illusion to create a *Führer*-persona by law (Schacht 1935). This speech had a profound impact on the debate about reform (Bayer and Engelke 2007; Klausing 1937; Schubert 1986b) although it did not 'disideologize' the reform nor the arguments brought forward (see Thiessen 2013). The *Führerprinzip* was mentioned time after time as a root for the new law and the main thrust of the reform remained anti-shareholder-oriented. What was ended, however, was the debate about the utility of the *Aktiengesellschaft* in general and the drive towards ever more restrictions based on Nazi ideology.

After reworking the draft, the new law was enacted in 1937. From today's point of view, three changes stand out: namely, the introduction of a general minimum capital requirement of 500,000 *Reichsmark*, reaching further than the limited one introduced in 1923, an answer to the *Aufsichtsratsfrage* and the strengthening of the executive board, combined with shareholder disenfranchisement (for a more detailed account Bayer and Engelke 2007; on accounting rules in the 1937 reform Schön and Osterloh-Konrad 2007). According to the official explanatory statement on the new law (*amtliche Begründung*), the *Aktiengesellschaft* was considered adequate for large enterprises only (see also Kißkalt 1934). In

other cases, the entrepreneur himself should carry the full risk of doing business.

One of the major innovations of the 1937 reform is the decision of the *Aufsichtsratsfrage* and, even more far-reaching, a fundamental reallocation of power and decision rights within the corporation. The reform disallowed the transfer of executive tasks to the supervisory board, making the executive board the sole and exclusive head of the corporation internally and externally. The law assigned to it the power to manage the corporation's affairs and to represent it in all matters to the executive board. There were only a few exceptions for very limited circumstances, such as representation of the corporation in transactions with members of the executive board. As a corollary rule, the law prohibited the transfer of these managerial powers to either the supervisory board or individual shareholders, or the shareholders' assembly. It was thus no longer possible for a shareholder to reign over the corporation via a seat in the *Aufsichtsrat*-made-second-executive board. Additionally, the shareholders' assembly's rights were severely restricted (see Bayer and Engelke 2007; Fleischer 2007). The shareholders generally lost the right to interfere with management. All they could vote on were appointments to the supervisory board, whose task, in turn, was to appoint members of the executive board. Turning away from any idea of 'shareholder democracy' and the model of shareholder-centric corporate governance established in 1861, the 1937 reform, in the well-known words of one seminal introduction to the new law, followed the acceptance of the '*Führer*-idea'. The 'anonymous capital' had its 'poisonous teeth' removed (Klausing 1937). Shares with multiple voting rights were abolished, *Vorratsaktien* prohibited (the latter measure being somewhat softened by the introduction of a new way to raise capital resembling authorized capital, the '*genehmigtes Kapital*', see Bayer and Engelke 2007).

From today's point of view, there remains an interesting question: what kept the drafters from proposing a one-tier system? The Nazis abolished the Weimar codetermination rules early on (see section 7). Moreover, the drafters underlined the importance of the *Führer*-principle. Additionally, they drew on US corporate laws as a model for corporations with a strong executive board. Indeed, some had argued along these lines. The majority opinion was, however, to keep the supervisory board for two main reasons (see Kißkalt 1934): first, it was thought that a smaller group with better insight into the corporation's business and needs would be better equipped than the corporation's *Volk* (the shareholders) to choose the executive board's members. Furthermore, the drafters believed to follow a trend in foreign corporate laws. They argued that even in

systems not expressly requiring a two-tier system, corporate practice had established either two boards as a governance standard, one with executive and the other with supervisory function, or a separate class of officers supervised by the board (Kißkalt 1934). This had already been the prevailing view in Weimar with explicit reference to English corporate law (Pinner 1927).

Besides the *Führer*-principle, the 1937 reform injected other elements of Nazi thought into corporate law: the new law allowed dissolving a corporation against the shareholders' will if the corporation endangered the 'common good' (*Gemeinwohl*). Even worse, it obliged the *Vorstand* to lead the corporation according to the needs of the 'well-being of the business (*Betrieb*), its retinue (*seiner Gefolgschaft*) and the common good of *Volk und Reich*'. Note that shareholders and their interests are not mentioned at all in the text (they are mentioned, however, in the official explanation, see Klausing 1937). As explained in a leading treatise on corporate law by one of the main actors in the legislative process (Schlegelberger 1939): 'The corporation has to economico-politically integrate itself into the German economy; all the corporation's matters are subordinate to those of *Volk und Reich*.' In other words: the *Vorstand* as *Führer* had to lead the corporation according to the common good as defined by Nazi principles (Mertens 2007). One might argue, however, that the common good and its protection had been a question debated in the Weimar Republic, just as the subordination of the corporation and its shareholders, most famously by Rathenau (see above; Fleckner 2007 conjectures the existence of a general trail of thought in Germany). For the Nazis, however, this clause was the means of transport of ideology into corporate law and enforcement of Nazi principles through state interference (see Mertens 2007; Thiessen 2009; Thiessen 2013; not convincing Kropff 2016).

Considering this kind of regulation and the general political environment, the question arises as to what extent the 1937 reform represents a work of Nazi ideology. Because the main pillars of modern German corporate law remain firmly grounded in the 1937 reform, this is not only important as a matter of interest for the legal historian, but for anyone dealing with German corporate law today.

Without question, there is an astonishing and discomforting amount of personal continuity. Men like Schlegelberger, Geßler and others who were part of the Nazi hierarchy and, to varying degree, involved in the promotion of Nazi ideology, held influential positions after 1945. Geßler, to give just one example, continued working in the department of justice and was a key player of the 1965 reform. For them, hinting at the preparatory work in comparative corporate law undertaken during the

times of the Weimar republic was a fig leaf lying readily at hand (see Thiessen 2013). And indeed, the official reasoning and introductions to the 1937 reform do situate this piece of legislation squarely within Nazi ideology and terminology ('*Führerprinzip*'). Additionally, there is no doubt that certain provisions were the product of Nazi thought, such as the *Volk und Reich* formula mentioned above. On the other hand, comparative legal research heavily influenced not only the preparatory work in Weimar. Even in the debate after 1933, US-American and English principles played a role (see von Hein 2008). Many justified the introduction of board authority and the shareholders' disempowerment, coined as the establishment of the *Führerprinzip* in corporate law, with reference to US corporate laws and their board-centric model of corporate governance (see *Aktienrechtsausschuss*, report on the session of 10 February 1934; von Hein 2008; critically Mertens 2007; Thiessen 2013). The reform did not even go as far as the US-American model. Shareholders did (and have) a lot more say in corporate matters than, e.g., their Delaware peers (e.g. distribution of dividends, capital increase, see Kuntz 2016a). With respect to the intensity and depth of the discussions of US and English law not only during the Weimar times, but also in the *Aktienrechtsausschuss* in 1934, it does not convince to ascribe the executive board's new and elevated position exclusively or predominantly to ideology (not convincing therefore Mertens 2007).

It is interesting to note that the corporate law reform of 1937 and, to a certain extent, the partial reform of 1931, moved German (civil) corporate law closer to US/Delaware (common) corporate law (for enduring differences see Kuntz 2016a; see also Fleischer 2007 with respect to the shareholder assembly's rights). Many economists try, with various explanatory strategies, to link corporate law and investor protection by law to stock market development (most (in)famously La Porta et al. 1998; see also Rajan and Zingales 2003). From this point of view, one could ponder whether bringing German law closer to US law was connected to changes in the stock market. At least for the period after 1933, this is an insufficient and highly dubious approach. It is well known today that the economy in Germany picked up in the early years of the Nazi reign not because of Keynesian economic politics, but as part of a general recovery already starting before 1933 (Buchheim 2003; Ritschl 2003; Spoerer 2005; Tooze 2005). Empirically noteworthy is the fact that although the German stock market had been very active until the crash in 1929, it did not pick up speed again when the economy recovered (see Burhop, Chambers and Cheffins 2015). Due to a massive state investment programme and other measures, state debt surged to new heights even before the war (Ritschl 2005; Tooze 2005). What has been

neglected is the extent to which the Nazi government early on intervened in business and business politics by measures other than corporate law. Since 1934, two laws had impaired dividend distributions: the *Kapitalanlagegesetz* subjected any corporation distributing dividends surpassing 6 per cent (8 per cent under certain conditions) to a forced investment in government bonds by the same amount. Just nine months' later, the *Anleihestockgesetz* went even further and disallowed any dividend distribution in cash of more than 6 or 8 per cent. Distributions surpassing these amounts had to be transferred to the *Deutsche Golddiskont-Bank* which in turn invested the money on behalf of the shareholders in government
(-backed) bonds (see Bähr 2006). Combined with follow-up regulation and changes in dividend taxation, this made dividend distributions over a certain amount economically unfeasible (Spoerer 1996; on later amendments of the *Anleihestockgesetz* until 1945 see Bähr 2006). Additionally, corporations tried to circumvent the rules by retention of earnings and building hidden reserves (Spoerer 1996). These regulations and practices took away incentives to invest in stock. The *Gesetz über wirtschaftliche Maßnahmen* of 3 July 1934, empowered the Secretary of Commerce (*Reichswirtschaftsminister*) to effectively govern in whatever way he chose, including over the investment policy of private enterprises. Whole industries suffered from a prohibition on investing other than by government *fiat* (Barkai 1988). Beginning in 1934/1935, the Nazi government used the private sector in order to pursue its goals with respect to rearmament and securing autarky, a large part of private sector investments were the result of demand originating in the sphere of government (Scherner 2013; Spoerer 2005; Tooze 2005; Tooze 2006). The government forced the organization of whole industries in so-called *Pflichtgemeinschaften*, i.e., in corporate groups (Barkai 1988; Tooze 2006). One example is the lignite industry, forced into the Braunkohle-Benzin Aktiengesellschaft (Brabag) in 1934 (Stokes 2003; Tooze 2005; Ziegler 2010; for the slightly different case of the pulp programme and staple fibre production see Scherner 2008). It is no wonder that stock market development floundered even before the war started, with the state intervening like this (see also Burhop, Chambers and Cheffins 2015).

7. 1945–52: EMPLOYEE CODETERMINATION LAWS OF 1951 AND 1952

The first significant legislative measures after the war in matters of corporate law were not changes of the *Aktiengesetz*. What truly shaped German corporate law, in a way non-Germans often seem to have trouble

comprehending, was the (re-) introduction of board-level codetermination. The *Montanmitbestimmungsgesetz* 1951 set a benchmark against which any future legislation was measured. For anyone interested in German corporate law, it is important to realize two key insights: first, the idea of codetermination was 100 years' old, from a German perspective, codetermination legislation did not come out of the blue; second, it is a result of the specific conditions after 1945. Not a few scholars consider codetermination one of the cornerstones of a specific German 'cooperative capitalism' and a key to the country's success after 1945 (e.g., Abelshauser 2011).

For a better understanding of how codetermination came about, it is necessary to trace both aspects just mentioned in greater detail. Codetermination legislation grew out of historical roots of worker participation in the mining and armaments industry and tied together several strands. The debate about worker participation rights began in the 19th century. It was motivated by a mixture of considerations concerning efficiency (channelling of workers' interests instead of a many-voiced choir), politics ([proto-]Marxist thought) and ethics (employer's responsibility as a *pater familias*, social catholic thought). The debate and the overall climate in the *Kaiserreich* (see Reichold 1995; Teuteberg 1961; on the debate in the highly influential *Verein für Socialpolitik* Teuteberg 1977) led to the *Gewerbeaufsichtsnovelle* 1891 (*Gesetz, betreffend Abänderung der Gewerbeordnung*; sometimes called the *Lex Berlepsch*), the first federal law giving workers certain participatory rights. After severe strikes of coal-mine workers in the Ruhr area, the most important region for the German coal and steel industry, 1900 and 1905 saw the introduction of mandatory participation rights in the Bavarian and Prussian mining industry (*Berggesetznovelle*; see Teuteberg 1961). In 1916, most workers were drafted and moved to the front. The government tried to compensate for the resulting labour shortage by forcing men who were not fighting to work in the armaments industry or other industries important for war purposes (*Gesetz über den Vaterländischen Hilfsdienst*). This law aimed at suppressing revolutionary tendencies and risked causing uprisings at the same time. After union intervention, the federal government agreed to grant mandatory participation rights (Reichold 1995; Teuteberg 1961). Two years' later, fearing the turmoil of a failing government, the German defeat and with revolution in plain sight, unions and employers alike feared the coming of the Council Republic (*Räterepublik*), a socialist form of government, with all its consequences on private property rights and powers of representation (see Winkler 2005). Therefore, Stinnes (representing the industry side) and Legien (representing the union side) hammered out an agreement, the

Stinnes-Legien-Pakt of 1918. Whereas the unions promised the continuation and return to work as well as measures against the councils, the employers granted improvements of working conditions and workers' rights, among them several participation and codetermination rights (Feldman 1984; Winkler 1984). On this basis, the government enacted a regulation in law at the end of the year, inter alia, replacing the 1916 codetermination rules which had been repealed in the meantime (Verordnung 1918, see Hainke 1987). In 1919, laws for the coal and potash mining industry followed, establishing industry syndicates and massive government intervention, a continuation of the interventionist policies concerning industries deemed strategically important (so-called *Sozialisierungsgesetzgebung*, see Plumpe 1999; Teuteberg 1981; Winkler 1984). The steering committees responsible for controlling the coal and potash mining industries (*Reichskohlerat* and *Reichskalirat*) were composed not only of employers and government officials, but also of employees' representatives. Additionally, the Weimar constitution demanded worker codetermination (see Ritter 1994). All these measures and the need to deal with the revolutionary *Räte*-movement eventually culminated in the 1920 *Betriebsrätegesetz* and its 1922 amendment (*Gesetz über die Entsendung von Betriebsratsmitgliedern in den Aufsichtsrat*), which laid the foundations for codetermination as of today. They provided for up to two employee representatives in the *Aufsichtsrat* with voting rights (Lutter 2007; Lieder 2006). The reasoning on the draft saw the reform for what it was – an 'innovation of completely fundamental nature […] following the belief that nothing is as suitable to increase enthusiasm for work, feeling of responsibility, and the interest in the improvement of company output and revenues' ([German] citation in Plumpe 1999). Under the Nazis, all workers' participation rights were abolished early on (*Gesetz zur Ordnung der nationalen Arbeit* 1934; see Winkler 1987; Kranig 1984; Ziegler 2010). In sum, in 1945, employers, unions and workers had histories and narratives they could draw on – a history of political debate and struggles surrounding workers' rights, codetermination laws abolished by the Nazis (and thus something one could legitimately want to have reintroduced), and the experience of defending employers' and unions' interests against third parties (Stinnes-Legien-Agreement) (critically with respect to the strength of this kind of narrative Müller 1991).

Of course, 1945 was not comparable to 1918. In 1945, the Allied Forces occupied Germany, assuming all decision powers. On the German side, the question arose as to what direction should be taken. Politically, even many conservatives pondered some kind of directed economy with a strong socialist flavour. In the eyes of many, capitalism was responsible

for the woes of the Weimar Republic and the dreadful experience with hyperinflation and stock market crashes. Additionally, especially from the perspective of Social Democrats and unions (and of the Allies), employers and 'capital' had supported Hitler's rise and the Nazi regime. Thus, turning away from 'Manchester capitalism' and those involved in the government which brought devastation to so many countries including Germany seemed to guarantee a better future (see Abelshauser 2011). From 1945 on, the unions demanded codetermination as part of a strategy to distribute power evenly in society and called for workers' participation rights. The Allied Control Authority permitted works councils in 1946 in the Law No. 22, which did not provide, however, for codetermination in the *Aufsichtsrat*. In August 1946, the British military government seized the coal and steel industry of the Rhine-Ruhr-area. It had plans to nationalize the industry. Not only did this fit in with the newly elected (socialist) British government's policies (which 'nationalized' the British coal mining industry in July 1946 [Coal Industry Nationalisation Act 1946]) in general, it also wanted to decartelize the business conglomerates. As the owners ('capital') were seen as part of the Nazi machinery (e.g., Ernest Bevin, Secretary of State for Foreign Affairs, speech of 22 October 1946), labour was the natural ally (Potthoff 1962; Teuteberg 1981). Several owners, especially those of steel and coal enterprises, were anxious to prevent nationalization measures. They voluntarily offered codetermination to the unions in order to win them as partners in the fight against the Allies' strategies (Teuteberg 1981; Müller 1991). This did not work out. Decartelization began in 1947, enforced by the North German Iron and Steel Control (NGISC). In the course of the decartelization measures, worker representatives became not only members of the newly incorporated entities' supervisory board (far more than 20), but as so-called *Arbeitsdirektoren* members of the executive board. The supervisory board was composed of an equal number of employee and owner representatives and one representative of the NGISC (Potthoff 1962; Teuteberg 1981). Thus, the parity principle in codetermination was born. From now on, the unions and Social Democrats had a model they could point to and which would serve as a benchmark in the years to come – representation of labour in the supervisory board on equal terms with capital. On top of that, they always could (and did) refer to the employers' codetermination offers in 1946 (see *Aktenvermerk* Henle 1951). This arrangement survived not only the amalgamation of the bi-zone, but also the creation of the Federal Republic in 1949.

In 1950, however, the Allied Control Council's successor, the Allied High Commission for Germany, promulgated the Law No. 27 on the reorganization of the German coal, iron and steel industries, aiming at the

elimination of concentration of economic power. The 'question of the eventual ownership of the coal and iron and steel industries should be left to the determination of a representative, freely elected German Government'. In line with this policy, the law's execution was given over to a newly created Steel Trustee Association replacing the NGISC. There was, however, no substitute for the codetermination arrangements. An early draft of the German department of economics for a regulation detailing measures executing Law No. 27 envisaged a return to German corporate law – and thus to a legal order without any rules on worker representation on the executive or supervisory board (Potthoff 1962; Teuteberg 1981). The German government stood at an intersection of several developments (on the following: Abelshauser 2011; with emphasis on codetermination and the *Montanmitbestimmungsgesetz* 1951 Müller-List 1985; Müller 1991; see also Potthoff 1962; Teuteberg 1981). The draft of a works council law was caught up in the mills of the legislative process and a political struggle attracting a lot of media attention. On the one hand, owners/employers attacked codetermination, even though the draft did not propose following the parity principle. On the other hand, for the unions the draft amounted to a major step back. Consequently, they threatened to enter a general strike and to paralyze the iron, steel and coal mining industry for early 1951. The government had to deal with this attempted blackmail and danger for the economy immediately. Since the start of the Korean War in summer 1950, the economy, especially in the iron, steel and coal mining industries, had started recovering (see Abelshauser 2011; Müller 1991). A general strike would have thrown Germany back into the ruins from which it had just emerged. Aside from this general political climate, Adenauer needed labour and the support of the unions for two other projects: to counter the Allies' decartelization strategy and to reach an agreement with the French on what was to become the European Coal and Steel Community (Müller-List 1985). The Allied High Commission kept a neutral stance. The Allies feared negative reactions at home from whichever side they worked against: in addition, they wanted to strengthen the labour movement as a force for democracy in Germany and were not interested in seeing the coal and steel mining industry as a strategically important industry on the rise again (see Fichter 1993). Under the guidance and pressure of Chancellor Adenauer, unions and owner representatives hammered out a deal, the so-called 'guidelines for codetermination in the coal and iron creating industries' (*Richtlinien* 1951). These guidelines granted codetermination based on the parity principle for companies in the coal, iron and steel industries and served as the basis of a new codetermination law cut out for these industries. In 1951, the Bundestag adopted the law on employee

codetermination in the supervisory and executive boards in companies of the mining, iron and steel industry (*Montanmitbestimmungsgesetz* 1951). The law is based on the parity principle and gives workers and shareholders the same number of seats on the supervisory board (with additional board members who have to be neutral). Additionally, one member of the executive board is effectively elected by labour (technically, however, by the supervisory board). For the unions, this was not victory. They pushed for codetermination in all areas, not only in the steel and coal industry. Furthermore, because of the way the decartelization was organized, some companies seemed to slip out of the *Montanmitbestimmungsgesetz*'s net (for a unionist's perspective Potthoff 1957). Following a dispute about the law's scope of application, subsequent strikes and political strife, parliament enacted the works council law 1952 (*Betriebsverfassungsgesetz*; see Teuteberg 1981; Reichold 1995). The codetermination rules established by the *Betriebsverfassungsgesetz* apply to all companies, no matter which industry they belong to. However, they grant only a third of the places in the supervisory board to labour (note: the *Betriebsverfassungsgesetz*'s codetermination rules were relocated to the *Drittelbeteiligungsgesetz* in 2004, but remained unchanged content-wise). In 1956, in a supplementary law to the *Montanmitbestimmungsgesetz*, the rules of parity-principle codetermination were extended to holding companies (*Montan-Mitbestimmungsergänzungsgesetz* 1956, see Müller 1991). This fight over codetermination in the coal, mining and steel industries was a game-changer at the time and still serves as a rod against which many unionists measure codetermination regulation. Because of these industries' decline, however, the importance of the *Montanmitbestimmung* today is limited from a practical point of view.

8. 1952–65: THE REFORMS OF *AKTIENGESETZ* IN 1959 AND 1965

Beginning in the late 1940s, several authors pushed for a major revision of the 1937 reform. They argued that the roots of strengthening the *Vorstand* together with the weakening of shareholder rights lay in Nazi ideology (e.g., Gierke 1948). The '*Führerprinzip*' so often stressed by the Nazi reformers was an argumentative lever, easily available from the official reasoning (see above). Government officials sang from the same hymn sheet (see Bahrenfuss 2001; Kropff 2007). Another consideration was the wish to make equity capital investments more attractive and invigorate the stock market (see Bahrenfuss 2001; Kropff 2007). Background was the financing culture of German corporations. They tended to

finance acquisitions of assets by drawing on their reserves. The *Aktiengesetz* 1937 allowed management to build large hidden reserves: income statements were opaque and unreliable, they did not, to give just one example, properly show details of sales revenues. These problems ran so deep that in the mid-1950s the New York Stock Exchange refused to accept German securities for trading (see Bühler 1957). Additionally, the rules restricting dividend distributions introduced by the Nazis (section 6) were still in place. These two strings, 'denazification' of corporate law and the improvement of German corporations' attractiveness for investors, overlapped. One of the first steps – and the easiest – was to abolish the laws limiting dividends in 1952 (see the official reasoning 1950 of the *Gesetz zur Aufhebung der Dividendenabgabeverordnung*). The ensuing debate about reforming the 1937 law ran along two basic lines. On the one hand, there were the leading bodies of German business associations and the Confederation of German Trade Unions, two unlikely partners who both pleaded for keeping a strong executive board and a weak shareholders' assembly (Bahrenfuss 2001; Kropff 2007). For the unions, this guaranteed a stronger position of labour with respect to codetermination. Only those decision rights allocated to the supervisory board and the executive board lay within the realm of employee participation rights. On the other hand, other interest groups such as the association for private investors (*Schutzvereinigung für Wertpapierbesitz*) demanded better shareholder rights and a weaker executive board (Bahrenfuss 2001; Kropff 2007). To a certain extent, this was the debate of the Weimar Republic with exchanged signs regarding the powers of the boards and the shareholders, respectively. As early as 1953, Chancellor Adenauer expressed worries that the population would diverge and end up in two strata, consisting of those leading the economy and those working in large firms or depending on aid for survival (see Adenauer 1953). Time after time, Chancellor Adenauer stressed the importance of creating capital and greater dispersion of ownership (e.g., Adenauer 1957). He demanded better transparency of earnings positions and increased shareholder influence (Adenauer 1957). The debate and legislative work concerning the reform lasted more than 10 years (see the detailed report in Bahrenfuss 2011).

To solve the problems caused by the weak provisions on income statements and financing methods (see above), the government spun off the necessary changes (see Bahrenfuss 2001; Kropff 2007). In 1959, a partial reform entered into force (*Gesetz* 1959). The contents of income statements had to be more detailed. Additionally, to facilitate increasing capital, the new law introduced an easier and more tax-efficient way to convert reserves into legal capital.

The enactment of the final reform came in 1965 (for an overview Steefel and von Falkenhausen 1967; for a more detailed report on the reform in light of its history Bahrenfuss 2001; Kropff 2007). Although once again a careful study of foreign corporation laws had preceded the reform, US-American law did not noticeably influence the 1965 law (von Hein 2008; differentiating Fleischer 2016). The two-tier structure of executive and supervisory boards remained unchanged. Proposals to switch to a one-tier system (e.g., Wiethölter 1961) had no success: one of the reasons being to keep employees off the executive board, which would have been the consequence of combining supervisory board and executive board into one. Furthermore, many pundits worried that the abolition of the supervisory board would have required compensation in terms of public oversight institutions comparable to the Securities and Exchange Commission. This was seen as creating the danger of unwanted state interference (e.g., Fischer 1955). As part of the 'de-nazification' of corporate law, the reform removed the possibility of appointing a member of the executive board as a chief executive with sole and final decision powers, expressly turning away from the *Führer-prinzip* towards the principle of collective responsibility and joint decision-making. Shareholder rights were strengthened, but there was no fundamental change in the separation of power (with an emphasis on voting rights: Noack 2016). Banks' proxy voting power for shares in their custody accounts (*Depotstimmrecht*) was limited to a certain extent. The shareholder assembly (re-)received a right to vote on profit distribution. Due to several limitations, however, the board(s) basically remained in control of the process (on the executive board's authority Kuntz 2016b). They kept the right to jointly decide on the annual balance sheets, and therefore the right to determine the amount of profits available for distribution. The counterweight to manipulation incentives were better transparency rules and the shareholders' right to call for a special audit (on accounting rules see Schön and Osterloh-Konrad 2007). Although some authors had made a case for proxy voting following the US-model (Wiethölter 1961), the legislator declined to change the German system of bearer shares which would have been necessary (Bahrenfuss 2001). Multiple voting shares were not entirely forbidden, but issuing them was made more difficult.

An oddity of the 1965 reform was the near-abolition of freedom of contract with respect to the articles of association. Without any real discussion and without probing the issue properly, the legislator held it to be an accepted principle of German corporate law tradition that in the articles of associations, any deviation from the *Aktiengesetz* was forbid-den if not expressly permitted in the *Aktiengesetz* (on this principle of

Satzungsstrenge see Kuntz 2016c). Today, a popular justification given by many authors is the importance of having a standardized legal form, making it easier to create and maintain an anonymous market for shares and thus to improve the functioning of the capital market. Notwithstanding the objections to this argument (see Kuntz 2016c), there are two points to keep in mind: first, the relevant provision does not apply to contracts other than the articles of association. It is common practice in Germany to conclude shareholders' agreements and contracts between the corporation and shareholders or creditors (e.g., in loan agreements), which are governed by general German private law and thus benefit from freedom of contract. This system does not run without frictions, but is flexible enough to find solutions viable for corporate practice and adapted to the needs of the parties, e.g., in venture capital transactions (see Kuntz 2016c). Second, the differences between German *Satzungsstrenge* and corporate laws with a lot more room for manoeuvre, e.g., the Delaware General Corporation Law, appear to be quite small: the articles of association of the majority of public Delaware corporations resemble each other quite closely (Hansmann 2006). Thus, the difference of mandatory and default approaches in corporate law proves not to be that great in practice (for further details and an explanatory theory see Kuntz 2016c). Taken together, these and other amendments in 1965 neither turned the clock back to corporate law before 1937 nor did they amount to a major upheaval. In the end, the 1965 reform breathed compromise.

It contained, however, one major achievement that is recognized as being one of the most significant legislative acts in German corporate law: the reform introduced rules on corporate groups (*Konzernrecht*; for a concise overview Altmeppen 2007; in detail Dettling 1997). From a historical perspective, Germany was a latecomer in antitrust regulation. Whereas the US Sherman Act was enacted in 1890 and complemented by two other laws in 1914, trust building was all the rage in Germany until the end of World War II. Even leading economists viewed organizing economic activity in conglomerates and corporate groups as an efficient way to do business, protected from 'ruinous' competition and fluctuation in the economy (see Spindler 1993; Spindler 2007; Dettling 1997). Beside dodging competition, tax law was the other reason for group-building. In order to reach a group-wide uniform trade taxation, tax authorities and tax courts required a contract between the members of the group ensuring obedience to the group's top (Spindler 1993; Spindler 2007; Dettling 1997). During the Weimar Republic, many powerful conglomerates came into existence: IG Farben in 1925, a major conglomerate in the chemical and pharmaceutical industry, Vereinigte Stahlwerke

in 1926, a big player in the iron, steel and coal industry, and Deutsche Bank und Disconto-Gesellschaft in 1929, the biggest banking enterprise in Germany (on these and other examples see Spindler 1993). It was completely acceptable to prefer the interests of the group as a whole over the interest of individual group members and their respective creditors (see Altmeppen 2007; Spindler 1993; Spindler 2007). In 1932, these 'industrial duchies' (Friedländer 1954) counted more than 80 per cent of *Aktiengesellschaften* as their subjects (Dettling 1997). The Nazis made it even worse by sometimes forcing businesses into group structures (section 6). The change came with the Allied Forces and especially US-British pressure to decartelize the coal, steel and iron industries (see section 7 above). The growing insight of needing some kind of antitrust regulation was accompanied by a rising awareness of problems connected with corporate groups other than distortion of competition, namely the weak position of minority shareholders (or 'outsiders') vis-à-vis exploitation by the majority and creditors with respect to risk-shifting and reallocation of earnings and assets in general (see Dettling 1997; Spindler 2007). Taking up these concerns, the government decided to address this 'problem of corporate groups' (*Konzernproblem*) by introducing special rules. The solution, still in place today, distinguishes between 'factual corporate groups', i.e., corporations bound by shareholdings, and 'contractual corporate groups', i.e., corporations bound by an 'enterprise contract' (see J. Vetter 2016 for a perspective on 50 years of corporate group law). In the first case, the 'reigning company', i.e., the mother company, may not direct the 'dependent company' to incur any cost without compensation. In the second case, the law allows for tight supervision of the subordinate group members. This requires, however, that the enterprise contract between subordinate and superior corporation is voted on with a supermajority of 75 per cent in the shareholders' assembly. Additionally, the corporate mother has to guarantee the solvency of the other group members.

9. 1965–76: THE CODETERMINATION ACT 1976

The 1965 reform, at least from the viewpoint of left-wing politicians and the unions, had left an important question unanswered: the question of codetermination according to the parity principle (see section 7 above). The chance to deal with this issue came with a shift in the political landscape. For 20 years the German Chancellor had been a Christian Democrat, but in 1969, in a major political change, Willy Brandt and the

Social Democrats moved into the driver's seat. With the Social Democrats, who would be the Chancellor's party until 1982, came pro-labour and union-friendly politics (see Abelshauser 2011). Chancellor Brandt declared the extension of codetermination to be one of the main tasks of his (second) chancellorship. He held it to be part 'of the substance of society's path to democracy' (Brandt 1973). Whereas the 1972 reform of works council law (see Teuteberg 1981) – to the disappointment of the unions – upheld the mode and scope of labour representation created by the 1952 works council law, 1976 saw the birth of today's codetermination regime's third cornerstone: the Codetermination Act 1976 (*Mitbestimmungsgesetz* 1976). Originally, Social Democrats and unions envisioned a grand reform of codetermination. They wanted to bring the 1951 model to bear on all corporations, but because the Social Democrats were tied in a coalition with the business-friendly Free Democrats, they had to make concessions (Abelshauser 2011). Adhering to their main aim of extending codetermination meant giving in with respect to thresholds (only companies with more than 2,000 employees fall under the 1976 Act) and concerning decision-making: even though there is parity in numbers of labour and capital representatives, in case of a tie the vote of the supervisory board's chairman is decisive. The chairman typically represents capital (on this and other details see Mertens and Schanze 1979). After the law was adopted by an overwhelming majority in the Bundestag (only 22 nays and one abstention) and barely upheld by the German constitutional court in 1979 (see Mertens and Schanze 1979), the 1976 Act as well as board-level codetermination in general now are firmly anchored as part of the core principles of German corporate and company law with a backing by constitutional law (see Kolbe 2013). The theory of the corporation as a 'thing in itself' as developed by Rathenau (see section 5 above) serves as the ideological basis, expressly referred to by the German constitutional court in its 1979 decision. There are critics. However, no German government, whatever its political colours may be, will risk the massive public outrage that would be most likely to follow any attempt at significantly curtailing codetermination. Even those deeming the current system, not without cause, excessive, plead for innovation, not abolishment (e.g., Neubürger 2004; Rieble 2004). Empirical studies so far are inconclusive (for details Bermig and Frick 2010; Bermig and Frick 2011; Fauver and Fuerst 2006). Many employers and representatives of the capital side see benefits resulting from codetermination rights, even among those not typically considered blind towards efficiency (e.g., the Head of Kohlberg Kravis Roberts & Co [KKR]'s European branch, Huth 2006; see also Neubürger 2004). It is remarkable, however, that no other European country has adopted a similar model.

Regulating corporate law on a European level was frequently inhibited or failed because Germany wanted to uphold codetermination rules. Additionally, with the introduction of the European Stock Corporation ('societas europaea' or SE), many German companies escaped the rigid German rules and adopted a more flexible model of codetermination (but this lies outside this chapter's scope: see Eidenmüller, Engert and Hornuf 2009).

10. CORPORATE LAW AFTER 1976 BETWEEN MICRO-MANAGAMENT, CAPITAL MARKET REGULATION AND EUROPEANIZATION

The reforms of 1965 and 1976 gave the final touches to the *Aktiengesellschaft*'s structure: the two-tier system, employee codetermination in the supervisory board, the centre of decision-making located at the level of the executive board with several rights kept for the shareholders, among them the right to decide on the distribution of dividends, increase of capital, conclusion of enterprise contracts and changes in the articles of association. Legislative action in the decades after 1976 concentrated on details and incremental change. At the same time, the frequency of legislation increased significantly, giving rise to the impression of reforms being the permanent state (see Habersack and Schürnbrand 2007; Hommelhoff 2016). Closer inspection reveals two overarching lines of development. Beginning in 1994, the *Aktiengesetz* developed into a regulation of what could be called two types of corporations: one the 'small *Aktiengesellschaft*', without access to public markets and not intended to be taken public (e.g., family-owned corporations, see Henssler and Wiedemann 2007), the other the public corporation. This tendency to better adapt corporate law to the economic realities is a welcome step away from the 'one size fits all' approach of old. These changes gave rise to the establishment of what some call *Börsengesellschaftsrecht*, a corporate law made and tailored for public corporations (e.g. Assmann 2015; Fleischer 2006).

This tendency to essentially split corporate law in two is complemented by the ever-increasing influence of capital market regulation (see Assmann AG 2015; Fleischer 2006; Habersack and Schürnbrand 2007; Hommelhoff 2016; Langenbucher 2016). To give just two examples: laws on corporate takeovers (*Wertpapiererwerbs- und Übernahmegesetz* 2001) and securities trading and insider regulation (Gesetz 1994) apply to publicly traded companies only and contain rules on questions which are

essentially corporate law questions, e.g., on the executive board's duties and rights to act against tender offers.

The second strand of development relates to corporate governance. One aim of regulation is to strengthen the supervisory board and provide it with better means to exercise control over the executive board (see Lutter 2007; Lieder 2006; Hommelhoff 2016; E. Vetter 2016; in comparative perspective Hopt 2008). Even though the members of the board may not be members of the executive board at the same time and the independence of supervisory board members has long been important to courts, most supervisory boards were not known for close inspection of the executive board. This had to do with the fact that often members of the executive board, after giving up their seats, became members of the supervisory board and were not overly keen on second-guessing their old decisions. Additionally, being a member of the supervisory board traditionally was not regarded as a full-time job. As only the supervisory board may bring actions concerning breach of duty, at least as a matter of principle, many pundits spoke of liability rules as dead law. To amend this situation, laws were made more explicit concerning the supervisory board's tasks and duties, and followed the call for a 'professionalization' of supervisory board members (Hommelhoff 2016; E. Vetter 2016). These measures have side effects, however, as the strengthened role of the supervisory board requires re-balancing the executive board's position in corporate governance (see Koch 2016). Besides the supervisory board, corporate governance legislation improved auditing standards and requirements and amended shareholder rights, especially minority rights (for an overview Habersack and Schürnbrand 2007; Hommelhoff 2016).

These and other reforms enacted after 1990 were driven by a changing corporate landscape. Whereas the 'Germany, Inc.' of old had worked within strong national networks of banks, labour and shareholders with large blocks of stock, the end of the century brought major shifts in the allocation of power: corporations adopted a more shareholder-oriented style of doing business, the number of foreign shareholders increased, a process accompanied by a steady decrease in the number of cross-shareholdings. Banks and insurance companies, the pillars of the old networks and highly influential players in the supervisory board (see Hopt 1997), divested their shareholdings and gave up their seats on the board. The German legislator had to react to these developments and took an active role in the dissolution of 'Germany, Inc.' (for an overview, Höpner and Krempel 2004; Windolf 2014; on an important tax law reform, Sørensen 2002).

Many of these measures have their roots not (only) in German politics, but stem from European legislation. Beginning with the First Council

Directive 68/151/EEC in 1968 ('Publicity Directive') on disclosure duties and the Second Council Directive 77/91/EEC in 1976 ('Capital Directive') on corporate capital, European legislation, together with the European Court of Justice, started to heavily influence the shape of corporate law (for an overview Bayer and Schmidt 2007; Möslein and Grundmann 2007; Verse 2016). This has not significantly altered the *Aktiengesellschaft*'s structure, however, especially as the important Capital Directive was modelled on German corporate law. An English initiative at the beginning of the 21st century wanted to abolish elements foreign to British corporate law, but failed in the end (see Lutter (ed.) 2006). Minimum capital requirements and preemptive rights, among other rules, still build the basis of the corporation in Europe.

11. GERMAN CORPORATE LAW IN CONTEXT: CORPORATE LAW, STOCK MARKET DEVELOPMENT AND COMPARING CORPORATE LAW

Especially for economists, German corporate law seems to have become more interesting in the course of the 'Law and Finance' movement. La Porta et al. claim to have established a nexus between German corporate law being worse than, e.g., Delaware law, and a comparatively weak stock market (La Porta et al. 1998). This research suffers from several fatal flaws, especially from its complete ignorance of the broader historical, social and legal environment of which German corporations are a part. Those interested in German corporate law after 1945 should take several factors into account, only some of which I wish to point out: apart from the other disruptions caused by the two World Wars, there were two instances of millions of people flowing into the German economy without any valuables to speak of, except for their talents. While the fall of East Germany, a bankrupt state with inhabitants who (naturally) had never paid a penny into the western social security systems, might be obvious, the other case is the inflow of millions of refugees from the former *Reich*'s eastern territories after 1945 (see Abelshauser 2011). Moreover, the pension system in Germany traditionally does not rely on the stock market (on the significance of this fact in comparative perspective see Vitols 2001). Whereas in the US, future pensions are a function of the employees' own private investments, in Germany, (*Reich*-)Chancellor *Bismarck* introduced a public retirement insurance in 1889, still at the core of the German pension system today

as set in a major overhaul in 1957 (see Abelshauser 2011). In Germany, current retirees' pensions are paid from the current employees' pension premiums. The vast majority of the workforce, far more than 80 per cent, is enrolled in the Public Retirement Insurance (*gesetzliche Rentenversicherung*; see *Versichertenbericht* 2016). As a consequence, there are no massive private pension funds creating demand (such as CalPERS in the US). What should also be taken into account is the lack of a legal requirement comparable to Section 12(g)(1) of the US Securities and Exchange Act 1934, forcing companies to 'go public' if they pass certain size-related thresholds. Many German companies would be public, were such a provision part of German law (see this chapter's introduction). Tax law and the incentives set by tax subsidies play an important role as well, historically as well as today (see Fohlin 2002; Sørensen 2002; Vitols 2001). These and other factors, alas, cannot be dealt with in further detail here.

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9. Change for continuity: the making of the *société anonyme* in nineteenth century France

Jean Rochat

I. INTRODUCTION

'The *société anonyme* [corporation] was established in France by the law of 24 July 1867' (Lemeunier, 1994, p. 10). This totally false assertion is the opening line in a popular textbook on corporate law that was widely used in the late twentieth century. In truth, the *société anonyme* (SA) had appeared for the first time in French law 60 years' earlier, in the *code de commerce* (Commercial Code) promulgated in 1807, the economic component of a widespread drive for codification that was initiated by Napoleon in the 1804 *code civil* (Civil Code). This legal innovation was itself only a formality: in practice it gave a name to, and regulated, older commercial practices dating back to the chartered companies of the seventeenth century.

However, Lemeunier's 'mistake', cited above, is not trivial, and reflects a clear tendency in French historiography to overlook uses of the *société anonyme* form that were not strictly capitalist. Consequently, Anne Lefebvre-Teillard and Charles E. Freedeman – the two foremost authorities on the history of the French SA – could agree upon a list of SAs formed in the 19th century that excluded not-for-profit organizations, even those explicitly founded as anonymous companies (Freedeman, 1979; Lefebvre-Teillard, 1985). This bias led to the exclusion of more than 15 per cent of relevant companies from their analysis and, more importantly, an obfuscation of the formative years of the SA. The period from 1807 to 1867 (the date of the first fundamental reforms to corporate law) represented a time of transition during which case law and uses of the anonymous form developed. It therefore does not have the coherence or homogeneity that those scholars who, *a priori*, associate the SA with the birth of modern capitalism, seek.

In tracing the principal stages of the development of corporate law in France, this chapter aims to situate this pivotal period of the nineteenth century in the context of the long, and non-teleological history of a legal

institution. Rather than denying the mercantilist origins of the SA, the aim is to bring them to light and to try to understand the slow mutation of the institution, notably between 1807 and 1867 when all SAs were required to obtain government authorization before they could be created. It should be noted from the outset that our approach is very different to a 'lawyers' legal history'[1] that represents the history of law in terms of a series of texts that were providentially introduced by the legislature. Instead, we focus primarily on the interaction between the law, jurisprudence and practice. Ultimately, it appears that chronologies and interpretations that overlook the social history of law to focus exclusively on legislative texts are mistaken. In practice, continuities and discontinuities are not often found where formal law suggests they should be. Consequently, we argue that the alleged rupture of 1807 (with respect to the SA) was, in reality, a vehicle for the continuation of practices, and in no sense led to a break with those of the *Ancien Régime* – despite the desire for them to disappear. On the contrary, the period between 1807 and 1867 was marked by a slow evolution, and although the corporate law remained unchanged, practices were reinvented, giving new substance to the institution.

Section II discusses the features and characteristics of the SA and compares them with other legal forms that were envisaged by the Commercial Code of 1807, as well as their British and American counterparts. Distinct perceptions of American corporations and the SA – despite their many similarities – help us to understand their different trajectories. Section III concerns the drafting of SA legislation in the first decade of the nineteenth century, and the practices that it fostered. Unlike the standard interpretation proposed in the historical literature, we challenge the illusion that the Commercial Code represented a break with an archaic past. The fourth section focuses on changing uses of the anonymous company form in the middle of the nineteenth century, and the legislative changes that followed in the 1860s. Despite continuity in the formal aspects of the law, practices evolved a great deal, inviting us to reflect on the driving forces for legislative change, and the interactions between formal law and practice that they generated. The reforms of 1863–67 put an end to the system of government authorization and made it possible to create an SA through a simple process of registration. Certainly it was a pivotal moment in the ongoing evolution of the SA, with the formal law responding to changes in practice. Nevertheless, these laws, although often presented as another discontinuity in the

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[1] In the words of Harris (2003).

history of the SA, once again served more as a vehicle for continuity than as the foundation for a new period.

II. FEATURES AND CHARACTERISTICS OF THE *SOCIÉTÉ ANONYME*

The corporation first appeared in French law in the Commercial Code of 1807. It was one of three legal forms available to businessmen who wanted to register a commercial association. The Code's definition of the corporation is minimalistic: it is referred to in only a dozen or so articles, which stipulate the principles of limited liability, the issue of tradable shares and the need for special authorization from the government prior to its creation. The fundamental feature that distinguished the SA from other legal forms recognized by the Code was the limited liability enjoyed by *all* partners. Unlike the general partnership (*société en nom collectif*), in which all partners were personally and fully liable, the limited partnership (*société en commandite*) divided partners into two types. General partners were responsible for the management of the company and as such were liable *in infinitum*, while sleeping partners owned stocks in the company; their liability was limited to the amount of their contributions, on the condition that they did not participate in the management of the business. The SA went a step further. In addition to these specific characteristics related to liability, it could divide its capital into shares (a prerogative that it shared with the *société en commandite*), and its existence was not intrinsically linked to that of its members, being an independent legal entity.

Compared to their British or American peers, nineteenth-century observers and actors in France had a very different view of the importance of the existence of a separate legal body. In the former two countries, it was what fundamentally distinguished the corporation from other legal forms: the common denominator in all of the very diverse examples of a corporation.[2] Moreover, the very term 'corporation' indicated that it was the constitution of a body that was able to act. This was not the case in France, where actors were more interested in the generalization of limited liability. It became literally known as the 'anonymous' company (*société anonyme*), precisely because none of its

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[2] For example, in the US, up until the 1850s some States had implemented general incorporation acts that did not recognize general limited liability (Hilt, 2015). In England, 'limitation of liability became an inherent feature of the joint-stock corporation only relatively late' (Harris, 2000, p. 33).

associates gave it their name or held personal liability. This characteristic, far more than the constitution of a legal body, is at the heart of the French *société anonyme*, to the extent that, unlike the situation in the UK and the US, it would have been unthinkable for them to be formed without general limited liability.

However, in France, the SA liability regime was deeply at odds with the spirit of the early nineteenth century. This was due to its inconsistency with what actors perceived as the necessary foundation for any business relationship: the commitment, by at least one individual, of their personal commercial credit. In the nineteenth century, the understanding of credit went well beyond simple financial guarantees, to include the confidence that a businessman inspired, and the resources (notably social and familial) to which he had access (Baubeau, 2007). Clearly such confidence was based partially upon financial guarantees but it also depended on a reputation for honesty, morality and seriousness. Thus, by undertaking commitments in his own name, and thereby risking his credit, a merchant built the trust that was necessary to establish a business relationship. In an SA, such a mechanism does not exist because nobody makes a personal commitment.[3] Consequently, contemporaries became very wary of this legal form, and for a long time it was regarded as an exception to ordinary law. In 1863, a parliamentary debate states that:

> Until now, we have considered that personal liability, not only in trade but also in civil matters, was the principle of ordinary law [*droit commun*]. The only exception was introduced for SAs that, as we have noted, were not companies subject to ordinary law, but exceptional companies, as they were subject to a very different system of government authorization, and these companies, moreover, were only authorized for certain types of businesses that appeared to be in the general interest or of [particular] importance.[4]

This special system for the liability of its partners and the perception of the SA as an 'exceptional' institution helps to explain the regulatory dispositions towards it in the first decades of the nineteenth century.

The most important of these dispositions was, without doubt, that its creation was subject to government authorization. The justification for

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[3] It is significant that the first article of the 1807 Commercial Code dealing specifically with the SA (art. 27) states that 'the *société anonyme* does not exist at all under a social name; it is not designated by the name of any of the partners'.

[4] Intervention of State Councillor Vuillefroy. Sitting of the legislature of 4 May 1863, *Moniteur Universel* of 5 May, 1863, p. 709.

this requirement was based on the idea that it was a substitute for the liability of partners:

> […] As *sociétés anonymes* differ from other companies in that it is not necessary to have partners who are held indefinitely liable for all social debts; […] as these partners, even when they are involved in the administration, cannot lose more than they have put in […], we anticipated all of the adverse outcomes that establishments of this kind could have for creditors […]. For this reason, in almost all countries, these kinds of companies are only allowed to be formed with the authorization of the legislature, or at least the government (Pardessus, 1857, pp. 137–8).

Specifically, individuals wishing to create an SA had to undertake a lengthy administrative procedure that could last from several months to several years. During this time, a multitude of actors (prefects, ministerial committees, the State Council, experts consulted by the administration) decided on, not only the financial capacities of the sponsors, but also their 'faculties', 'quality' and 'morality'. Their opinion was also required with respect to the usefulness of the business, its chances of success and compliance with 'morals, good faith in business matters, and a good order of business in general'.[5]

Until the 1867 Act that ended the authorization system and allowed the creation of an SA by simple registration, only around 750 companies were established, in a limited number of sectors. Together, infrastructure and transport (233), insurance (203), banks and building societies (112), and the industrial sector (91)[6] represented almost 85 per cent of new businesses. Compared to the overall number of new commercial companies, these figures were very low: between 1840 and 1880, about 75–80 per cent of commercial companies were formed as general partnerships, and 20–25 per cent in the form of limited partnerships. These numbers show that the anonymous company was never more than marginal (Guinnane et al., 2007; Verley, 2003, pp. 88–93). Between the 1880s and the First World War this proportion increased significantly (10 per cent in the 1880s, 12 per cent in the 1890s, 14 per cent in the 1900s and 17 per cent between 1910 and 1913) but the real transformation only occurred from 1925, following the introduction of the limited liability company (*société à responsabilité limitée*; SARL), a legal form that was rapidly adopted by nearly 90 per cent of new companies.

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[5] See the *Instruction ministérielle* (Ministerial Statement) of 23 December 1807 reproduced in Jordan and Malepeyre (1833, pp. 437–9).

[6] To a very large extent composed of mining, metallurgical and glass companies.

Interpreting the SA's characteristics

The literature has generally been unambiguous in its interpretation of the characteristics of the SA. The standard argument can be summarized as follows:

(1) the SA has all of the features needed for the practice of an emerging industrial capitalism, notably by enabling the division of risk and the attraction of widely-dispersed capital. It was designed to be the legal response to the needs of an economy in revolution;[7]
(2) the State, jealous of its quasi-monopoly in the financial markets (for the issuance of debt), sought to restrict and control its development through government authorization (Freedeman, 1965, p. 190; Lévy-Leboyer, 1964, p. 701);
(3) The reforms of 1863–67 marked a victory for the business community over the backward-looking state; it finally managed to wrest the SA out of the government's claws to deliver unfettered private capitalism.[8]

This story is based on the intrinsic qualities of the anonymous company (general limited liability and the issue of negotiable shares), and above all the uses of the SA in the second half of the nineteenth century (continuing into the twentieth century) as the preferred instrument for large-scale private capitalism. However, the story changes dramatically, notably its chronology, if we shift the focus to actors' understanding of the SA and the uses they actually made of it. Later in this chapter we attempt to discard the idea that the SA began life in the early nineteenth century, and instead highlight its more distant origins (although in other forms). We then show that it only slowly became a support for private capitalism, remaining for a long time an instrument of state economic policy. In this context, we highlight the illusory effects of formal legislative changes (whether in 1807, or 1863–67) and evaluate continuities and discontinuities through a focus on the practices and representations of the individuals who made and used the law.

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[7] This is the story that is usually presented in a few lines in legal textbooks. See e.g., Constantin (2012).

[8] More-or-less explicit versions of this argument are found most in the work that either directly or indirectly addresses it. See, e.g., Freedeman (1979), Hilaire (1995), Lefebre-Teillard (1985), Lévy-Leboyer (1964, p. 701) and Ripert (1951).

III. THE SA IN 1807, A NEW INSTITUTION?

The Roots of the Société Anonyme

In the early nineteenth century, SA law (and, more generally, the Commercial Code) did not aim to found a new order of business, but rather to restore the old order that had been overturned by the Revolution. The first commentators on the text are very clear:

> The spirit that dominates the new Code, the thinking that shows itself in every provision, is to remind business of the purity of principles, to remove it from the state of degradation that the demoralization of recent times has led it to […]. The restoration of commerce is the sole purpose of this Code' (Fournel, 1807, pp. xii–xiii).

The drafters of the Code themselves admitted that they drew most of their material from the Colbert Orders of 1673–81, and the only novelty was what was said about bankruptcy (*Commercial Code Project, presented by the Committee appointed by the Government on 13 Germinal year IX*, 1801, pp. vii–xxxvii).

In terms of corporate law, any appearance of innovation is an illusion. While general and limited partnerships were already present in the 1673 ordinance, this was not the case for the SA, which is why the Code has been seen as a legally discontinuous move in the direction of modern capitalism. However, the real innovation of the Code was that it included the SA in the corpus of 'ordinary' law texts, rather than inventing a new institution. The SA, as it existed in the early nineteenth century, was nothing more than a new form of chartered company, a form that was notably used in transoceanic trade (in the seventeenth century) and, later, for printing money. These semi-public companies were instruments of State power and prestige and consequently benefitted from many privileges. They were all 'exceptional' and, as such, exempt from the usual trade regulations. More than an institutional tool in the hands of private business, they were an instrument of government economic policy; therefore, Colbert saw no need to include them in the companies listed in his Orders.

As the Commercial Code was being drafted (1801–07), legislators had to clarify their intentions regarding the SA, and they invariably referred to the old chartered companies:

> The need for movement has led to the birth of public institutions that are generally recognized as useful. Their beneficial influence on credit, in places where these institutions exist, especially in some trading nations, has made us

think that they will soon form in the towns of France where trade is limited […]. These large commercial associations are ordinarily created by *stocks* […]. Public banks, commercial establishments either in remote regions or that require a sumo of capital that is beyond the reach of ordinary associations establish themselves [in this form]' (Gorneau, Roux, and Legras, 1803, pp. 19–20).

To sum up, the Commercial Code simply renamed the institution and integrated it into ordinary law. Here again, the most perceptive commentators on the Code make no mistake, 'The *société anonyme*, which is a new creation in our legislation is in fact not: it was in use prior to the Commercial Code; but no law generally acknowledged it and determined its rules; even the name was never enshrined in any ordinance' (Jourdain and Malepeyre, 1833, p. 172).

In French historiography, this mercantilist origin of the SA has been largely overlooked, such has been the desire to see it as the embodiment of a new economy that broke with the system of privileges and legal exceptions that were characteristic of the abolished *Ancien Régime*.[9] However, highlighting these roots provides a way to understand how actors in the early nineteenth century perceived and used the institution. Far from the popular interpretation found in the literature, which emphasizes a fundamental conflict between the State and the private sector, and which is claimed to account for the limited number of new SAs, our perspective calls for an alternative explanation.

The practices that were observed, whether they related to regulation or how such companies were used, were unlike current commercial practices and suggest that the SA was reserved for very specific purposes. These purposes shared a principal characteristic: its use was only perceived as legitimate insofar as the company contributed to the public interest. This suggests a legitimation system that itself was strangely reminiscent of the political economy of privileges under the *Ancien Régime*. In exchange for a contribution to the general interest, a commercial company was granted the privilege of being able to take the form of an SA, a privilege that actually lay in its general limited liability and the implied notion of State prestige. The close corporation, which is local and does not address the public interest, is therefore absent from the

[9] Note that in this respect, historians of American law were more perceptive and have for a long time highlighted these origins, which have many similarities with the French case. See for example Handlin and Handlin (1945), Hovenkamp (1988) and Livermore (1935).

French legal literature although, as we shall see, it would have been useful to have (if only to understand its practices).

Representations and Uses of the Société Anonyme

Armed with this understanding of what the SA meant for the actors of the early nineteenth century, a number of behaviours or practices that appear difficult to understand can be easily explained. First, we note the indifference that the SA inspired in the business community. When, in 1801, the drafters of the Code first circulated a draft text in order to gather feedback from the national business community, only a tiny minority deemed it necessary to provide an opinion on the SA. Following the entry into force of the Code in 1808, requests for authorization were limited: only a few dozen files are documented[10] and just over 30 SAs were created between 1808 and 1818. When the business community was not indifferent to the idea of the SA, their opinion seems to have been dominated by distrust for a legal form that was widely perceived as a support for dishonest businesses. For example, the Paris Chamber of Commerce, while very ready to complain about regulatory barriers, for a long time defended the system of government approval 'in the name of protecting the public against "schemers" who would seek to enrich themselves without incurring any liability' (Lemercier, 2003, p. 56). This distrust was still very evident in the 1860s; in discussions about the proposed liberalization of the SA, industrial circles proved hostile to State disengagement, denouncing 'a certain school of economists who see barriers everywhere' and judging the new legislation 'useless and dangerous'.[11]

The SA was therefore very widely thought of as reserved for specific, mainly public, purposes. That perception explains the initial indifference of the business community to the SA, and its distrust when the privilege of forming an SA appeared to be opened up to the private sector. In the decades that followed the promulgation of the Code, the uses that were made of the SA make these representations clear (see Figure 9.1 below). The presence of new SAs can be largely understood in terms of their contribution to the public interest. This statement does not mean that there was no motivation to make money in these ventures, but rather that

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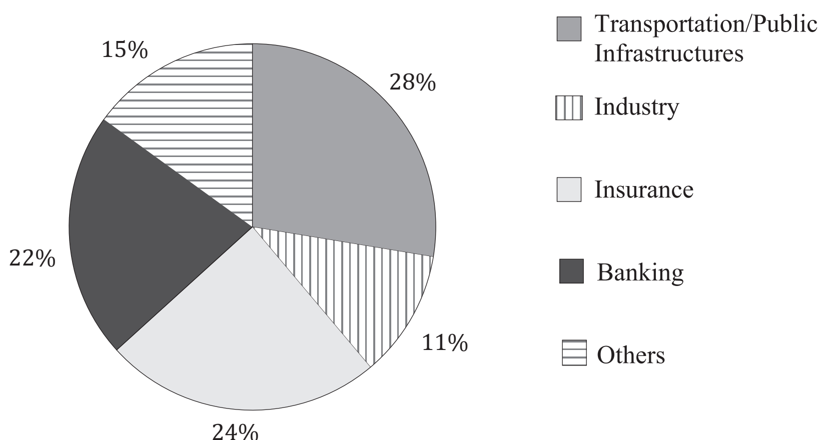
[10] For documentary reasons it was not possible to accurately count the number of failed requests, but the evidence suggests that during the entire period, 40–50 per cent of requests were authorized.

[11] National Archives of France, *Mémoires des chambres de commerce relatifs au projet de loi sur les SA*, AN C//1093. See also Courcelle-Seneuil (1865).

the state sought to encourage companies and industries that had a positive impact on a wider public than just their partners. Before the railroads era, the most-represented sector (transportation and public infrastructure) was composed by canals companies, companies that built bridges and ran steamships. This shows a willingness at state level for national territorial unification in order to accelerate the country's economic development. The emblematic embodiment of the idea is seen in the Becquey Plan of 1820–1822, which aimed, under the aegis of the state, to form several SAs that would implement a comprehensive, national canal network (Becquey, 1820; Geiger, 1984).



Source: Author's database.

Figure 9.1 Sectorial repartition of authorized SA 1808–1839 (n=373)

Almost half of the companies in the second-largest sector (insurance) were non-profit mutual insurance companies. Many others were marine (in ports) or agricultural insurers, where a professional community created an SA to provide a service to itself. The banking, savings and credit sectors were also comprised of predominantly public companies. Before the banking revolution in the second half of the century, over 80 per cent were savings and contingency funds set up at the initiative of a municipality to encourage the working classes to save. Other banks in industrial centres, intended to act as relays for the Bank of France, were encouraged by the government. Finally, industrial establishments (in particular in the mining and metallurgical sectors) were encouraged

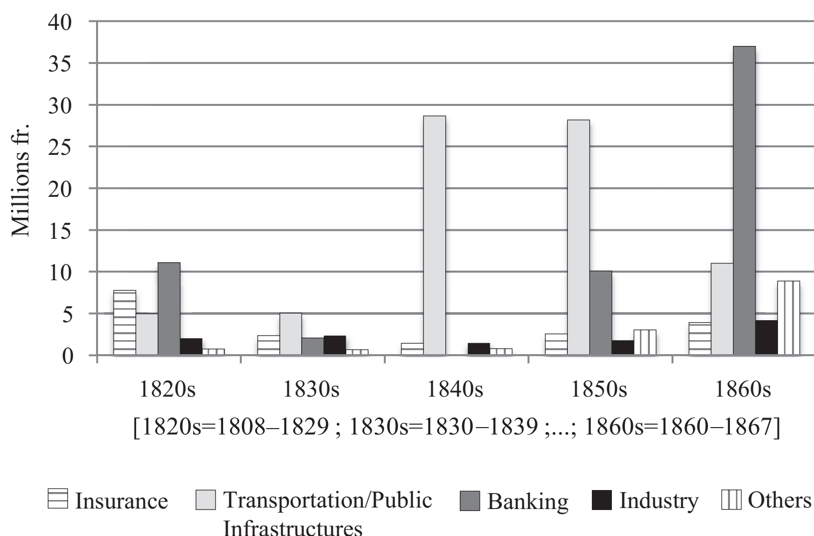
because of their military importance, and in a spirit of national competition with the country's British neighbour.

The SA of the first part of the nineteenth century could therefore be seen as a vehicle for the continuation of old practices, but in a form that was acceptable in post-revolutionary France. This formal transformation has deceived many scholars, who have described the SA as an essentially modern institution, and emphasized the contrast with an archaic and timorous State that for many years tried to control it. In practice, popular perceptions of the SA, the laws and regulations that related to it, and the uses made of it, were generally very coherent. What is clear is that this institution was not, first and foremost, a legal support for the birth of industrial capitalism. For this purpose, the Commercial Code offered alternative legal forms, notably the *commandite par actions* (limited partnership). However, little by little, new uses and understandings of the SA would be invented that were to provide a legal foundation for large-scale capitalism, notably in the guise of railways and joint-stock banks. We examine this diversification of uses in the following section, before summarizing the long history of changes in SA law.

IV. THE DIVERSIFICATION OF USES OF THE SA AND LEGISLATIVE CHANGE

The Commercial Code did not put an end to a political economics tainted by mercantilism. Nevertheless, at least with regard to the SA, it led to a renewal of institutional forms and their names that was intended to perpetuate practices in a transformed ideological environment. From the 1840s, in the absence of any legislative change, new uses were found for the SA in response to changing economic structures.

The railway sector was emblematic of these changes, and to some extent, the only clear example of them. First, companies became drastically bigger: the average capital of companies in the transportation and public infrastructure sector had increased nearly six-fold before and after 1840 (see Figure 9.2 below). Moreover, this sector included companies whose capital could not be measured against the standards of previous periods: 200 million francs, for example, for the *Compagnie des chemins de fer du Nord* or the *Compagnie des chemins de fer de Paris à Lyon*, authorized respectively in 1845 and 1846. The banking sector, which was no longer composed of small savings institutions, but joint-stock banks, would soon follow, reflected by some emblematic examples: the *Credit Mobilier* and its 60 million francs of capital in 1852, together with 60



Source: *Author's database.*

Figure 9.2 Average capital of authorized SA, by sector

million francs for *Crédit industriel et commercial* in 1859 or 120 million francs for the *Société générale* in 1864.

The SA therefore became the legal support for businesses that were typical of large-scale capitalism during the industrial revolution, and their uses were more consistent with classical descriptions of this legal form. Clearly, here the purpose of SA was to be able to attract small amounts of dispersed capital in order to fund companies that exceeded the financial capacity of an individual or their personal network, thereby facilitating risk management by limited liability. This new use of the SA can be seen in the figures below, which show stocks issued by companies (see Figures 9.3 and 9.4 below). The first lesson that emerges concerns the number of securities issued, which grew significantly in all sectors, and particularly clearly in the banking and transport sectors. Mean values increased from a few hundred to several thousand francs, and sometimes even several tens of thousands. This was the case, for example, for the *Compagnie des chemins de fer du Nord* that issued 400,000 stocks in 1845. At the same time, the nominal value of stocks decreased significantly in all sectors, and 500-franc stocks became standard in the banking and transport sectors (see Figure 9.4). The latter development reflected a desire to stimulate interest in commerce among sections of the population

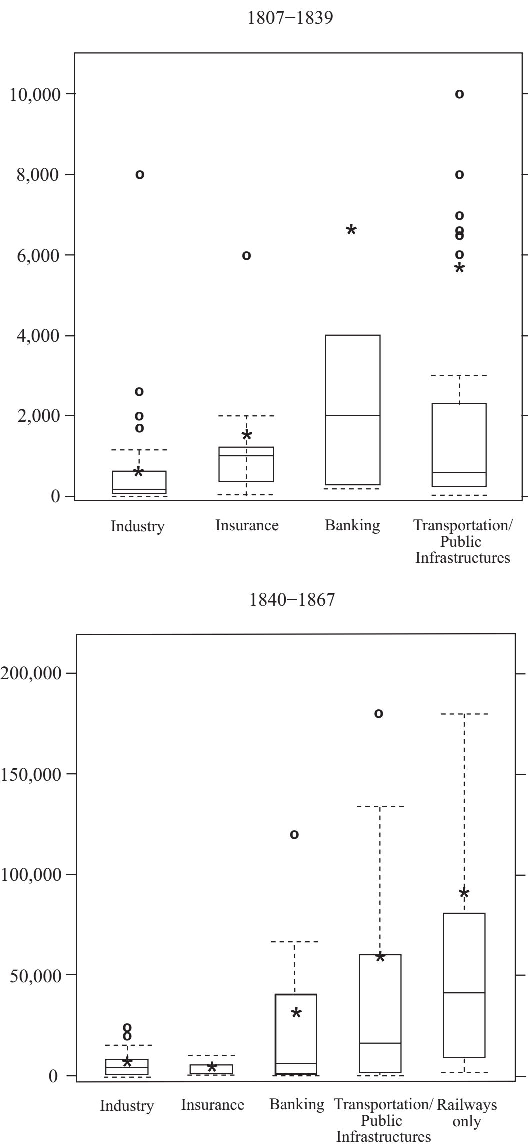


Figure 9.3 Number of shares issued[12]

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[12] Interpretation of boxplots: the box represents 50% of the observations. Its lower limit is the first quartile (25% of observations), its upper limit the 3rd quartile (75% of observations). The black line inside the box represents the median. Both whiskers delimit 1.5x the interquartile distance. The black star is

that had hitherto been excluded. A logical extension was for these new companies to initiate trends towards listing on the stock exchange. The notion of the general interest faded, and links with the State gradually weakened, although they remained strong in the case of railway companies, which were subject to the law of 1842 that defined the network and the principal lines.

'The firm, in the opinion of a business historian, from now on will be less familiar with its stockholders than its capital […]' (Gille, 1959, p. 39). Did the SA finally fulfill its promise of true anonymity? To some extent, yes. Stockholdings significantly expanded and restrictions on stock transfers were gradually lifted, meaning that it became more difficult to identify the company's owners. In practice, it was no longer possible to link a railway company to a family or a small business community, as was the case for most industrial or insurance companies where stockholdings were very limited, homogeneous and stable over time (Rochat, 2014). That said, these new large companies were not completely free of the aura of the family name. The big names of (usually Parisian) finance could still be found at their head; sometimes competing and sometimes combining to develop projects that were beyond the ordinary scope of business. Consequently, the Laffites, Pereires, Rothschilds or others, even if they had a limited share of the capital, remained the big names in railway companies and joint-stock banks.[13]

Furthermore, the scope of these developments should not be underestimated. Business historians have to a very large extent focused on a small number of cases (notably banks and railway companies), suggesting that such companies were typical of this period.[14] It could be argued that this limited focus is justified, because such companies were the face of new capitalism. However, they should not unduly distort our understanding of the French economy of the nineteenth century. The second lesson we can draw from Figures 9.3 and 9.4 lies in the vast heterogeneity of values, both within and between sectors. Figure 9.3 shows that in the banking and transport sectors, averages are always above the median, sometimes by significant amounts, indicating the presence of a small

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the mean, the white dots are outliers. For readability reasons, I fixed an upper limit to the vertical axes, otherwise the boxplots were flattened down by some extreme values (which do not appear anymore).

[13] See for example, Gille (1970).

[14] It could be said that in France, each of the big companies of this period has their own historian who studied them in detail. See, to only cite two emblematic examples, Bouvier (1961) and Caron (1973).

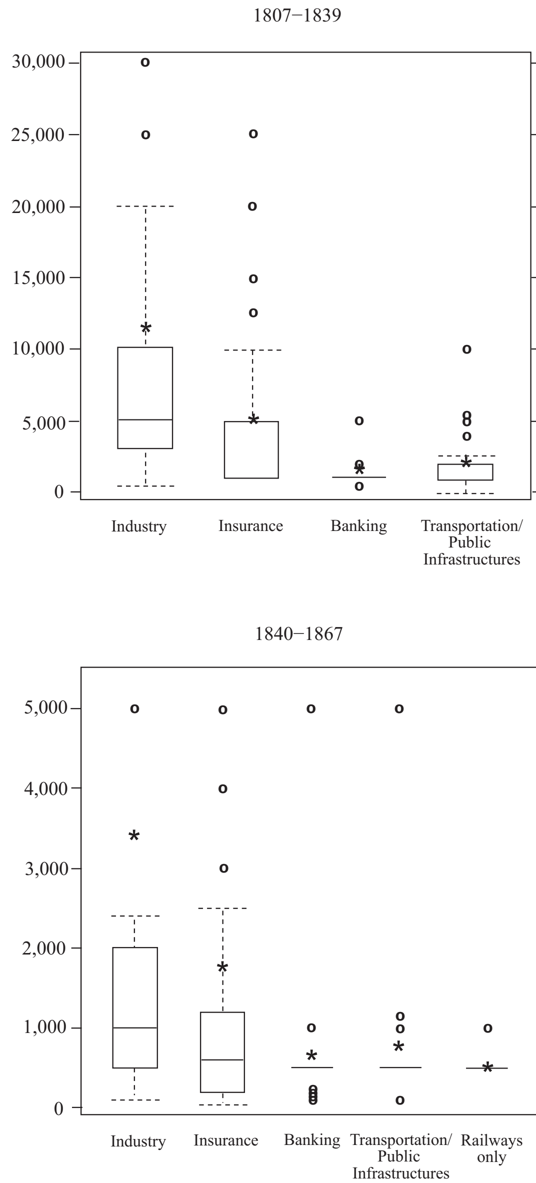

Figure 9.4 Par value of shares (francs)

number of very-high-value companies.[15] The insurance and industrial sectors are far more homogeneous, suggesting more uniform practice seen, specifically, in few stock issues but with a high nominal value. As for the nominal value of securities (Figure 9.4), conversely, practices are far more standardized in new sectors, while extreme values are found in traditional sectors, both before and after 1840.[16] These indicative figures provide an outline of both typical uses and the diversity of practices. The invention of new uses for the SA, by banks and railway companies, therefore appears to be unusual. It was confined to very specific companies, and did not challenge the ongoing use of older customs, which remained the norm.

In the vast majority of cases, the companies that were created remained close corporations: they had a relatively small amount of capital (at least not significantly greater than that of *commandites pas actions*), few stocks were issued with a high nominal value. Moreover, in the 1850s and 1860s very few SA were listed on the stock exchange, apart from railway companies, a few mining companies and some large banks (Hautcoeur, 2007). Finally, company statutes very often contained strict provisions aimed at controlling stock transfers. This was very far from the 'modern corporation' described by Berle and Means in which ownership was separated from control. Stockholdings remained relatively limited,[17] stable, homogeneous and controlled by a small group of individuals.[18] The anonymous character of these companies was therefore completely relative, and in reality they were very closely associated with a few of their most important members. More than a paradigm shift, therefore, the 1840s saw the diversification of uses and representations of the SA.

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[15] Note that most of these extreme cases do not appear on the boxplots above, where the Y-axis has been shortened to improve readability.

[16] A new record was reached in 1824 for the company *Verreries de Baccarat*, which issued eight stocks at 125,000 francs each for a total capital of one million francs.

[17] The median size of stockholdings was a little more than 20 stockholders for the period 1808–39 and just over 40 for the period 1840–67 (data from the author's database).

[18] The average number of stockholders holding 50% of stocks in an SA was a little over seven for the period 1808–39, and just over 11 for the period 1840–67.

The Laws of 1863 and 1867

So far we have seen that a change in the use of the SA occurred, while the laws that governed them did not. Following the enactment of the Commercial Code in 1807, the first reforms to SA legislation were seen in two laws that were passed in 1863 and 1867. Divided into two stages, these Acts allowed an SA to be created by a simple process of registration – first, in 1863 only for companies with capital of less than 20 million francs, then in 1867 for all SAs. At the same time, they became subject to more detailed provisions than those contained in the Commercial Code. While these laws put an end to the system of government authorization, they integrated the case law that had been established over the preceding 60 years through the practice of the authorization procedure. Included in this regard were the liberalization of stocks and the liability of principal stockholders; the evaluation of contributions in kind by commissioners; the distribution of dividends; the creation of a reserve fund; and the operation of various societal bodies, etc. Although the SA was no longer subject to a lengthy, expensive and arbitrary authorization procedure, the change did not really offer greater contractual freedom to businessmen. It could be argued that in abolishing the case-by-case assessment of the SA, it became apparent that its uses had changed. The SA was no longer the exceptional instrument of the State that it had been in the first half of the century, and it became clear that corporate law was not, by its very nature, a law of exceptions. Parliamentary debates in which these laws were discussed record the moment in detail, notably the words of the Parliamentarian Émile Ollivier, which were spoken at the time everything changed, and marked the point when the SA could begin to be considered as an institution subject to ordinary law:

> The Minister of State said: 'When you create an SA, you are beyond common law, it is a legal exception, and in this exceptional case, you must be subject to exceptional regulation like the Convention itself.' That, gentlemen, is a point of view that I cannot subscribe to. When a corporation is created, it is not a legal exception, it is part of common law (*droit commun*) applicable to associations (Ah ah). It is certainly not the usual law of individual commitments, but it is part of the usual law of capitalized associations, and there is just as much liability as if the commitment was personal; the only difference is that it is restricted and limited […]. When one commits oneself, liability is unlimited; when one commits one's capital, liability does not disappear into

> the world, because a company with no liability would be a monstrosity; but it restricts and limits itself [...].[19]

Once again, this radical change (to all appearances) is in reality only formal, and it does not affect the substance of the institution. The 1860s Acts once again provided continuity of practice, rather than new practices: they only standardized case law that had been slowly established by actors in the course of the authorization procedure.

The literature often presents these laws as the outcome of a long-standing power struggle between the State and the business community: the first seeking to keep the economy under control, the latter invariably fighting for greater freedom (Lefebvre-Teillard, 1993; Ripert, 1951, p. 61). This interpretation requires greater nuance. First, as highlighted above, the SA was not really any freer post-1867 than it was before, if we consider the freedom that the business owner had to draw up their company statutes. This is seen in the words of Freedeman who wrote, '[a] regular external structure and a system of internal governance had been added to the bare framework of the code' (Freedeman, 1979, p. 144). While 'liberalizing' the institution of the SA, the Acts of 1863 and 1867 added to the legislative framework that applied to it. Second, the blocks in the supposed balance of power between the private sector and the State were not very clearly defined. Most chambers of commerce in the major port and manufacturing cities voted against the bill, clearly showing their ongoing distrust in the institution. Parisian high finance, represented at the parliament by the Péreire brothers, was strangely quiet: they did not participate in the debates of 1863 and 1867, or in the final vote. Surprisingly, the most active members in the debates, such as Jules Simon, tended to lie to the left of the political spectrum, and spoke on behalf of cooperatives and societies who saw the legal form of the SA as best-suited to their activity. In principle, the abandonment of government authorization seems to have been accepted by everyone, even before the parliamentary debate began. The lengthy debates therefore focused on specific articles that aimed to overcome the hazards created by a lack of personal liability: the protection of minority stockholders and third parties, the distribution and monitoring of power within the company, the protection of capital through the introduction of accounting rules and the distribution of dividends. This pattern suggests that there was no obvious conflict between freedom and *dirigisme*, between the economic and the political, or between the business community and the State. Instead, what

[19] Intervention of E. Ollivier, legislative hearing of 4 June 1867 *Moniteur Universel*, 5 June 1867, p. 684.

we observe is a project of judicial reform to reflect the updated practices and representations of the SA that had already emerged in French society, and that open the way to new practices in return.

The Slow Evolution of SA Law

The 1867 Act established the foundations of the legal framework for the SA in the twentieth century. By facilitating the procedure for the creation of an SA, this Act opened the way for a significant increase in the number of new companies (*Compte général de l'administration* … , 1880). The annual number of new companies created increased to a few hundred, compared to an average of around 10 prior to 1867. Indeed, the increase was such that, at the outbreak of the First World War, there were 13,000 SAs in France (Freedeman, 1993). Nevertheless, the number remained far from the 63,000 corporations in the United Kingdom, or the 250,000 in the United States (Guinnane, Harris, Lamoreaux and Rosenthal, 2008, p. 83).[20] Another century passed before there was any further substantial reform to the legal framework of the SA in France. It was only on 24 July 1966 that new, far-reaching corporate legislation came into force – 99 years to the day after the 1867 Act, France adopted the new law on commercial companies that 'is more indicative of an evolution than a revolution. It codifies scattered provisions, it takes into account case law, it clarifies, it rationalizes. But it does not really innovate' (Guyon, 1994, p. 4).

Over the long run, therefore, we observe two striking patterns in the unfolding of legislative change with regard to the SA in France. First, there was a constant back-and-forth between, on the one hand, the drafting of a coherent body of law from heterogeneous and disparate texts and, on the other hand, the disintegration of this unified law through a multiplication of orders, decrees or jurisprudence. The 1807 Code sought to unite the proliferation of practices and regulations that had developed under the *Ancien Régime*, while the 1860 Act was an update to the Commercial Code that incorporated the jurisprudence forged during the intervening period. The 1966 Act, in turn, was intended to 'clarify, put in order and codify corporate law that was in true legislative and regulatory chaos', and which 'was found in various codes, various special laws that were repeatedly reworked and in numerous texts that had never been incorporated into the basic provisions' (Houin and Goré, 1967,

[20] Note that these numbers must be interpreted carefully, as these institutions are never perfectly identical in different countries (Hannah, 2014).

p. 123). In the 2000s, we observe a renewed enthusiasm for codification and the reintegration of SA law into the Commercial Code (Monéger, 2004).

The slow evolution that we observe in France was not entirely autonomous as it was affected by external factors, notably the law of neighbouring countries as well as modifications to alternative legal forms.[21] Certainly, this was the case in 1863–67, when reforms were introduced that were, at least in part, a reaction to the 1856 Joint Stock Companies Act in the UK, the Treaty of 30 April 1862 that authorized British companies to freely operate in France and a French law of 1856 that significantly strengthened restrictions on publicly traded partnerships (Doughi, 1979). And we observe a similar pattern in 1925, with the introduction of the limited liability company (*société à responsabilité limitée*) into French law. This innovation aimed to allow companies in regions that had been recovered from Germany by France during the First World War (in the form of GmBH) to continue to operate in an equivalent form under French law. Following its introduction, the limited liability company immediately became, by far, the most common legal form in France.

The second pattern concerns the terms of the debate, which remained remarkably unchanged. In 1807, 1867, 1966 and the 2000s, challenges related to the regulation of SA were couched in terms that, to a certain extent, hardly altered. In contemporary terms, the question is framed in the following way: is the company a *contract* between individuals who are free to shape it as they wish, or is it an *institution* that imposes its rules on the individuals who wish to be its members. There is a particular insistence on the fact that corporate law must be governed by the general principle of freedom of contracts. Equally important, however, is that this freedom must be organized and limited to protect the interests of third parties, or correct information asymmetries. Consequently, all of the legislative challenges, reforms and debates focused on the best way to limit the *liberté des conventions* (an ubiquitous expression in the second half of the nineteenth century), without negating its virtues. The archives of authorization applications from the first half of the nineteenth century (during which time the body of case law was slowly formed) are full of examples of these trade-offs:

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[21] The need to understand the law and the use of the anonymous company, taking into consideration all types of companies was highlighted by Guinanne, Harris, Lamoreaux and Rosenthal (2007) and Lamoreaux and Rosenthal (2005).

> I am far from pushing back these principles of freedom, I know as well as anyone that manufacturing companies in general cannot prosper if they are hampered by too many prohibitive measures that may restrict their operations; but I think that in the application of this principle, there is a great distinction to be made between general and limited partnerships, and public companies; only the first should enjoy absolute freedom under the law, because the public knows that it has a guarantee in the personal solvency of managers […]. But the only guarantee offered by the *sociétés anonymes* authorized by the King is that their capital must be subject to all precautionary measures, which tends to maintain this capital intact and ensures the long-term survival of the company, and as a consequence the rights of third parties and those of stockholders […].[22]

Nearly half a century later, in 1863, the constraints and freedoms of entrepreneurs remained the subject of parliamentary debate:

> Freedom is a very great and very beautiful thing, even with respect to commercial companies, provided however that with respect to the commercial company, as in any other matter, there should be corrective mechanisms in place without which it would be an abomination, a formidable danger, I do not hesitate to say this, on the condition that there should be as a correction the liability of the person who benefits from it. If you leave us free, and do not make us liable, you are doing a detestable work, and I do not want anything to do with your freedom.[23]

In the absence of constraints, it could be said that the freedom offered to small stockholders and third parties was, above all, 'the freedom to be eaten by the predators of finance'.[24] With respect to the 1966 Act, legal textbooks generally consider that the principal innovations included 'strengthening the security of third parties, the protection of associates and [the multiplication] of criminal accusations' (Merle and Fauchon, 2016, pp. 45–6).

Finally, at the dawn of the twenty-first century, although the vocabulary had (slightly) changed, the problem remained: in a report, submitted to the National Assembly in 2003, on a potential reform to corporate law, the authors wrote that they believe 'unswervingly in liberty and the contract as the way to regulate the company, and also in its key corollary, transparency, and in the principle of liability that sanctions it […]. For

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[22] Report by Brochant de Villiers, *Forges et Fonderies d'Imphy* sitting of the General Mining Council of 13 April 1829 National Archives F[14] 17942.

[23] Intervention by E. Ollivier, legislative hearing of 4 May 1863. *Moniteur Universel*, 5 May 1863, p. 709.

[24] Intervention by H. Quesné, legislative hearing of 28 May 1867. *Moniteur Universel*, 29 May 1867, p. 644.

the system to work in the future it must be based on three pillars: freedom, transparency and liability'.[25] Ultimately, the story of the SA's legal framework (at the beginning of the twenty-first, as in the early nineteenth century) is as a sequence of step-by-step rearrangements of the principles of freedom and accountability to position and reposition the limits of contractual freedom.

V. CONCLUSION

This overview of nineteenth century legislative changes and uses of the SA in France has highlighted the slow evolution of an institution that began life as an essentially mercantilist company form. This pivotal period of slow change is one in which the appearance of sharp discontinuities is misleading. The reforms of 1807 and 1867, which have been traditionally interpreted as such discontinuities, instead ensured continuity. Real change in the legal meaning of the SA actually occurred between these two dates, through an evolution of case law, practice and, more generally, a new shared understanding of the institution of the SA. The SA gradually lost its essentially public dimension, to instead become a legitimate instrument of private capitalism. The legal provisions that characterized it (general limited liability in particular) were gradually integrated into ordinary law, rather than constituting a legal exception. This chapter's reinterpretation of the origin of the SA and its history in the nineteenth century allows us to reassess the actions of the legislator and the government (which have been severely criticized in the literature), and to better understand the reactions of the business community. And, in avoiding the narrow prism of a public/private opposition, we gain a better understanding of the various actors.

The legal changes that we have described also suggest a more nuanced view of a second fundamental opposition, found in a vast body of literature and following the work of La Porta and his co-authors (LLSV): namely the opposition between civil and common law (Beck, Demirgüç-Kunt and Levine, 2003, 2005; La Porta, Lopez-De-Silanes, Shleifer and Vishny, 1998). The argument put forward by LLSV that civil law systems have difficulty generating legal rules that are as high-quality as those of common law systems has been challenged by many scholars (Armour, Deakin, Lele and Siems, 2009; Guinanne and Rosenthal, 2009;

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[25] *Rapport d'information sur la réforme du droit des sociétés*, No. 1270, introduced by Mr. Pascal Clément, 2 December 2003, p. 59 and 61.

Musacchio, 2008; Musacchio and Turner, 2013; Pistor, Keinan, Kleinheisterkamp and West, 2002). Although this chapter does not attempt to assess the quality of French law with respect to the SA, it counters the ideas of the LLSV in a different way by suggesting that there is not such a great difference in the operation and development of commercial law in countries operating according to a civil law regime and those with a common law[26] system. In France, case law was a major driver of the legislation changes that began in the nineteenth century and continued into the twentieth century. To focus only on codified law is to overlook this crucial dynamic since jurisprudence and practice have been able to substantially change the outputs of the law without changing its letter. 'Commercial law is the perfect example of customary law', wrote a prominent lawyer in 1838 (Wolowski, 1838, p. 10). It would seem that, in nineteenth-century France, that reality was widely understood. Although it is obvious that commercial practice was codified, great attention was always paid to leaving merchants sufficient flexibility to carry on their affairs. Therefore, each moment of codification was followed by a period of de-codification, which eventually becomes a re-codification. In practice, French commercial law was not nearly as static and rigid as the stylized description provided by LLSV suggests, and the dynamics of change are not so very different to those found in the common law system.

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[26] See Gordley (2000) and Martinez-Rodriguez (2016) for similar arguments.

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10. Classes of shares and voting rights in the history of Italian corporate law

Giulio Sandrelli and Marco Ventoruzzo

INTRODUCTION

The history of shareholders' voting rights is an essential part of the development of corporate law, and has always been at the core of the debate on corporate governance and finance. Shareholders' voting rights have often been the battleground of choice for interest groups, policy makers and scholars with different perspectives on fundamental ideas such as corporate democracy, investors' protection and market efficiency. Even more interestingly, the evolution of this specific issue offers a unique prism through which we can disperse and observe different waves of economic, legal, but also social and cultural transformation.

Describing even briefly the trajectory of this evolution from the birth of the first prototypes of the modern business corporation in the 17th century to our days would be impossible in the space of this chapter. A complete understanding of the relationship between equity investment and corporate powers would require, in fact, discussing numerous and heterogeneous rules, institutes and practices that concretely affect the position of shareholders, from shareholders' agreements to the technicalities of shareholders' meetings; not to mention broader economic issues that play a crucial role in the law in action. In addition, different jurisdictions have obviously followed different paths, with the consequence that identifying general, transnational trends is both difficult and potentially questionable from a methodological perspective.

For these reasons, we have confined our discussion in several ways. First, while not ignoring comparative perspectives, we will focus our attention on the evolution of the Italian legal system from the end of the 19th century to the present days. Italy offers an interesting example with respect to the issue of proportionality between equity investment and voting power for more than one reason. Even if in the last decade institutional investors have been gaining traction, throughout Italian history concentrated ownership structures have prevailed. In these situations, the key agency problem is not, as in the Anglo-Saxon systems

with widespread ownership structures, the one between directors and executives on the one hand, and shareholders on the other; but rather the one between controlling and minority shareholders. This feature of Italian capitalism makes the issue of voting rights particularly relevant and delicate. In addition, since the unification of the country in the 1860s, Italian corporate law and the scholarly debate that shaped it have presented an interesting combination of rules and approaches inspired by foreign experiences (French, German and, more recently, British and American), and very original solutions. The consequence is that Italian corporate law might be considered a living experiment in comparative law that allows to indirectly also consider other systems.

Another way in which we have limited the analysis is to concentrate on the narrow question of how flexible and liberal the legal system has been in allowing the creation of shares with limited or multiple voting rights, often organized as separate classes, or the direct attribution of different rights to specific, individual shareholders. We will enrich our discussion with a few detours on contiguous legal issues necessary to put the evolution of these rules in context, but we believe that this clearly defined perspective allows us to be more specific on the evolution of one institute, but also to offer an illustration of broader issues.

The chapter is organized as follows. After an overview of the evolution of voting rights in Europe and in the U.S. since the development of the first forms of modern business corporations, we will briefly describe the major milestones of the development of Italian corporate law from the second half of the 19th century. Finally, we will specifically discuss limited and multiple voting shares dividing our analysis in two paragraphs. The first will consider the period inbetween the 1882 Commercial Code and the enactment of the 1942 Civil Code. The second (and final) one will take a look at the most recent developments from the end of World War II to the present day.

A BIRD'S EYE VIEW OF THE EVOLUTION OF VOTING STRUCTURES FROM THE ORIGINS OF THE MODERN BUSINESS CORPORATION

Keeping in mind the caveats made in the Introduction, before dwelling in our discussion it is helpful to paint, in very broad-brush strokes, the development of shareholders' voting rights in the last three centuries in the Western world.

The British East India Company and the Dutch *Vereenigde Oost-Indische Compagnie* are, of course, only the most famous (or *infamous*) among the first prototypes of the modern business corporation that sprang up from the early 18th century to exploit the new and immensely promising trading opportunities generated by maritime explorations and colonization. Limited liability of the investors was an important innovation of this new type of organizations, but probably equally important for their early development were other legal attributes, such as the monopolistic rights on specific goods and areas of the world, and their quasi-state powers. In 1670, for example, Charles II granted to the East India Company the power to command troops, declare war and peace, mint money, and administer criminal and civil justice in its territories overseas (Chaudhuri 1965). These exceptional creatures, with 'no body or soul' (as Britain's Lord Chancellor Edward Thurlow famously defined them; Poynder 1844) defied centuries of legal thought and practice, rivaled with Nation-states, and caused or precipitated historical conflicts that reshaped geopolitics, from the Opium Wars to the American Revolutionary War.

Until the approval of the first general incorporation statutes, these unique entities were created through ad hoc permissions, at first granted by the sovereign and, later on, by bills adopted by the legislature. The highly discretionary and case-by-case granting of charters was a recipe for privileges, inequality and corruption but, most importantly for our purposes, did not encourage legal standardization and uniformity, especially in the area of corporate governance.

With respect to shareholders' voting rights, in particular, plenty of different solutions appeared in corporate charters throughout the 18th and 19th centuries, and singling out a recurrent model would not be easy. It is, however, relatively common the observation that these early corporations were characterized by a significant degree of 'democracy'. In fact, very often each shareholder had one vote on key corporate decisions, independently from the number of shares owned and the investment made.

The 'one-shareholder, one-vote' approach, however, was only apparently democratic. To begin with, the very fact that charters were granted discretionally, either by the crown or by legislatures, limited access to the corporate form to only a small, privileged, influential and connected part of the population. Secondly, the general idea of equal voting rights for each individual shareholder was in reality adapted by corporate practice, and a myriad of charter provisions effectively kept smaller investors out of power, for example providing that each shareholder had only one vote, but only if he owned a minimum number of shares.

The adoption of general incorporation statues, towards which most Western jurisdictions gravitated inbetween the end of the 19th century and the beginning of the 20th, was one of the major watersheds in the history of corporate law. General incorporation laws made chartering simply a matter of satisfying a few – more or less rigorous – objective conditions, fostering a more effervescent economy and bringing a measure of democracy to the system. The adoption of these statutes naturally required a trade-off: greater ease to incorporate a new business was compensated by greater rigidity, more mandatory rules and the obligation to conform to more detailed statutory models. A certain degree of standardization was – we can argue – a by-product of making the corporate form, and the benefits of limited liability, more readably available to a broader segment of the population.

In elaborating their corporate laws, different systems adopted different balances between mandatory and enabling rules, with some U.S. states already engaging in regulatory competition with their neighbouring jurisdictions in the late 19th century and, therefore, adopting more permissive rules. This was for example the case of the New Jersey and Delaware, with their 1896 and 1899 'enabling' statutes.

It is in this period that the principle of proportionality between investment and voting rights started to spread, at least as a default rule. It is fair to say that most jurisdictions followed one of two approaches. Some systems leaned towards the 'one-share, one-vote' model, or in any case favoured proportionality between cash flow and voting rights (even if, of course, bylaws could generally opt out of these rules). This was, for example, the case of Germany with the 1861 ADHGB (La Sala 2011). Other legislatures – including the Italian one with the 1882 Commercial Code – envisioned rules that would cap or proportionally reduce the power of *larger* shareholders through so-called 'prudent-mean rules'. In this category we include, for example, rules providing one vote per share up to five shares, one vote per five shares from 10 to 100 shares, and one vote per 20 shares above that threshold. Countries as diverse as Belgium, Italy, Portugal and Switzerland adopted at one point or another some type of variation of this mechanism.

It is in this period that the idea of 'corporate democracy' as it is generally meant today – i.e., one vote per share – developed (Dunlavy 2006). Previously, in fact, 'corporate democracy' meant granting equal voting rights to each individual shareholder, while – not surprisingly – proportionality between votes and investment was seen as a form of questionable plutocracy. Toward the end of the 19th century, a 'capitalistic' regime, in which power was allocated proportionally to contributions to the joint enterprise, became so broadly accepted that diversions from

this approach were deemed 'undemocratic'. The terminological shift witnesses the triumph of capitalism.

Interestingly enough, more or less in the same period, the power of majority shareholders was enhanced also by other reforms, such as the gradual abandonment of unanimity requirements to approve extraordinary financial transactions and major amendments to the corporate contract (Thompson 1995). Also in systems granting one vote to each share rather than to each individual equity holder, small investors retained a veto power on decisions requiring unanimous consent. Soon, however, policy makers realized that unanimity was an inefficient relic of the past, incompatible with the needs of the modern corporation. It was consequently abandoned in favour of majority rules (dissenters were granted new protections, such as appraisal rights – *see* Thompson 1995).

If 'one-share, one-vote' and 'prudent-mean' rules were the most common default rules in the first half of the 20th century, virtually no system made them rigidly mandatory, and contractual freedom could depart significantly from the basic model. The history of limited and multiple voting shares after World War II is, basically, the story of how broad was the latitude granted to the governing documents of a corporation to alter the proportionality between equity investment and control. Even if the pendulum oscillated between greater and lesser freedom, the direction in most systems has been towards greater flexibility and, once again, Italy is a case in point. This evolution has surely also been driven by regulatory competition among different jurisdictions and the international circulation of different models, but how corporations use this increased freedom largely depends on the prevailing ownership structures, which of course have also evolved. In particular, the possibility to issue limited or multiple voting shares has potentially very different dynamics and effects today, in light of the growing role played by institutional investors in most countries, then just one decade ago.

Let us now consider how this evolution played out in the Kingdom of Italy, before, and the Republic of Italy, later.

VOTING RIGHTS AND CLASSES OF SHARES UNDER ITALIAN LAW FROM THE XIX CENTURY TO THE 1942 CIVIL CODE

Italy did not exist as a unified country until 1861, and before the Independence Wars Italian legal history is, in fact, the history of the

different kingdoms and small states that composed the peninsula (Mack Smith 1988).

Not only did corporate governance and voting rights differ from one state to another: also within a single state, each charter could adopt its own tailored solution, vetted by an ad hoc governmental authorization, as mentioned above. If we look at the charters of the corporations formed in the 17th and 18th centuries, we rarely find a capitalistic 'one share, one vote' principle, while a 'one-shareholder, one vote' rule is sometimes set forth. More often, 'mixed' solutions were adopted, whereby voting rights were subject to minimum ownership thresholds, ceilings, 'prudent-mean' mechanisms and various combinations of the above (Ungari 1993). This rich array of solutions – influenced by the international experience of merchants and bankers from Genoa, Venice and Florence – was considered an effective balance between more plutocratic regimes and shareholders' participation at the dawn of Italian corporate law (Jaeger 1976; La Sala 2011).

In 1806, at the apex of Napoleon's expansionism, we witness the first – and unsuccessful – attempt at a comprehensive regulation of voting rights and shareholder meetings' decision-making process. This happened in the areas of Northern Italy, from Milan to Venice, subject to direct French domination (the so-called Kingdom of Italy, 1805–14), where a project of commercial code was envisioned with the goal of regulating all 'commercial companies' (Sciumè 1999).

The implementation of this project came to a halt when, two years' later, the French Commercial Code of 1807 was directly adopted in the Kingdom of Italy and all the other Italian regions (such as the Kingdom of Naples) annexed to the Napoleon's empire (Padoa Schioppa 1992). The French Commercial Code included rudimentary corporate law rules but, differently from the above-mentioned 1806 Italian bill, was utterly silent on the governance of the shareholders' meeting and voting rights.

The extension of the French civil and commercial codes to Italy is a relevant and influential event for the subsequent development of Italian business law, since it created a legal environment particularly receptive to French law, a characteristic that persisted for decades, well after the advent of the Restoration in 1814. The new Italian kingdoms, created in the aftermath of the Congress of Vienna, passed their own codes, which generally combined French legal foundations with local traditions and peculiarities. No differently from their French model, the newly-adopted Italian codes, such as the Code of the Kingdom of the Two Sicilies of 1819 (applied in the Southern peninsula and in Sicily) and the Sardinian Commercial Code of 1842 (applied in the Piedmont area and in Sardinia) did not regulate shareholders' meetings and voting rights in any detail.

It is only in the infant united nation that, with the occasion of the elaboration of the 1865 Commercial Code, voting rules start creeping in some draft bills. In line with the general tendencies of the period, these proposed rules generally provided for one vote for each shareholder. A more stringent and detailed regulation of voting rights was, together with other rules, a counterbalance to the envisaged abolition of governmental authorization to incorporate.

The 1865 Code, however, rejected general incorporation and, in keeping with the traditional approach, granted to the contracting parties almost complete freedom on the entire regulation of voting rights and shareholders' meetings. This old-fashioned approach – which did not even consider the French reforms after 1807 – faced increasing criticism. The Code was seen as inadequate for the delayed, but now rampant, country's industrial development. The battle-cry of entrepreneurs and bankers for liberalizing the incorporation process, in line with the international trend, could no longer be ignored (Padoa Schioppa 2010). France itself, in the wake of the U.K. reforms, had abolished the governmental authorization regime in 1867 to boost private investments, giving rise to a '*fièvre de commandites*' (Altaroche 1840). Germany had also followed a similar path with the approval of the *Aktienrechtsnovelle* of 1870, whereby the abandonment of the *Konzession* system had been accompanied by the introduction, among other things, of the mandatory supervisory board (*Aufsichtsrat*).

Under the urgency of modernization, a new Italian Commercial Code was elaborated starting from 1867 and approved in 1882. It is, in fact, only with this Code that Italy adopted a general incorporation law while making corporate law more rigid and detailed. A few key protections for shareholders and creditors counterweighted the abolishment of the governmental control. For example, the constitutional documents (and the relevant amendments) had to be 'homologated' by the judiciary, in order to ensure the lawfulness of the incorporation process. Founding shareholders had the obligation to pay in a minimum percentage of the subscribed shares (three-tenths of the par value of the shares). Each shareholder had the right to challenge the shareholders' meeting resolutions violating statutory or charter rules. On the governance front, the law clarified that directors faced joint and several liability in cases of breach of their duties, and shareholders obtained the right to appoint a board of auditors with supervisory functions (Ungari 1974).

In this Code, shareholders' voting rights followed two pivotal principles. First, each shareholder was entitled to vote at the general shareholders' meeting. Second, a prudent-mean voting rule, with a three-step system, was the default rule, modifiable by the corporate

contract. According to Article 157 of the 1882 Commercial Code – inspired by the U.K. model – equity investors had one vote per share for the first five shares they owned, one vote for every five shares up to 100 shares, and one vote for every 20 shares if they owned more than this amount (Padoa Schioppa 1984).

This voting system adopted in the 1882 Code stems from a compromise between the need to enhance effective shareholders control over the management, and the favour towards private ordering. Consequently, clauses that used to condition voting rights upon the ownership of a minimum number of shares, though customary at the end of the 19th century in Italy, were outlawed. A similar fate met other common bylaw provisions, such as non-voting shares and 'industrial shares' (i.e., mezzanine interests equipped with limited voting rights) (La Sala 2010; Portale 1974). The idea was to empower minority shareholders, in an attempt to foster 'corporate democracy' and create incentives for equity investment.

The prudent-mean rule, too, intended to curb the 'irresponsibility' of the 'capital power' and, as the Official Report to the Code warned, avert the danger coming from 'the aggregation of too many shares in few hands'. Law makers apparently feared a disempowerment of the shareholders' meeting due to the exercise of control by entrenched investors owning a majority of the shares. However, this default rule could be (and often was) contracted around and the voting system of each corporation adapted to a variety of solutions, from *per capita* voting to the capitalistic 'one share, one vote'.

The 1882 Commercial Code remained in force for 60 years, even if, as we will see below, several reform projects had been discussed especially starting in the 1920s. Particularly important for our analysis were the 'Vivante project' of 1922, the 'D'Amelio project' of 1925 and the 'Asquini project' of 1940, from the names of the persons chairing the commissions entrusted with drafting the new rules.

In 1942 the commercial code and the civil code were merged into the Italian Civil Code, enacted during the Fascist period but with only limited concessions to the ideology of the dictatorship, that were expunged after the Liberation. The new Code included an extensive set of rules governing corporations. One-share, one-vote became the default rule, but the new statute also clarified that departures from this principle were possible, even if within specific and quite rigid limits.

Multiple voting shares were expressly prohibited and only limited voting shares (as opposed to non-voting shares) could be issued. More specifically, the only type of voting limitation that could be adopted was granting voting rights only in the so-called 'extraordinary' shareholders' meeting. In this composition, shareholders can vote only on amendments

to the governing documents of the corporation, and other extraordinary transactions. In other words, it was possible to issue shares with no voting rights in the 'ordinary' meeting, in which shareholders appoint and remove directors, approve financial statements and lawsuits against directors, and authorize distributions. Limited voting shares also needed to be 'compensated' for their lesser administrative rights with enhanced economic rights, e.g., a privilege in the distribution of dividends. Finally, the total amount of limited voting shares could not exceed 50 per cent of the outstanding capital.

As we will see below, in the roughly 75 years that separate us from the original version of the Civil Code, this rather rigid approach was gradually relaxed. Before considering this more recent period, however, against the backdrop that we have briefly sketched, let us consider more profoundly the economic interests, practical needs and leading scholarly ideas that influenced the development of Italian law in this intellectually rich but also tormented and conflicted period.

VOTING RIGHTS AND CLASSES OF SHARES IN THE DISCUSSIONS ON THE 1882 CODE REFORM

Italian Corporations and Banks during the Second Industrial Revolution. The Crucial Role of 'Mixed Banks'

In the last decade of the 19th century, the Italian economic system underwent a Second Industrial Revolution, though as a 'second comer' following the major European countries. A combination of tax incentives, public investments and, above all, a strongly protectionist customs policy favoured a rapid expansion of a capital-intensive industrialization, especially in the iron, steel and energy sectors (Crepax 2002; Castronovo 2006).

This almost unprecedented economic expansion was accompanied by a hectic increase in the number of newly-incorporated companies (from 336 in 1896 to 2,932 in 1908 in the manufacturing industry alone; Crepax 2002), many of which were admitted to trading on the various and largely unregulated stock exchanges then operating in Italy (Milan, Turin and Genoa were the main ones). Between the mid-1890s and 1907 the number of listed companies reached its maximum peak ever (Costi 2010): in 1910, an outstanding 73 per cent of all the shares issued by Italian corporations were traded on a stock exchange (Baia Curioni 1995).

The transformation of the Italian banking business was a key to the industrialization process and the stock exchange momentum during this period. In 1894 and 1895, upon the initiative, and with the decisive support, of German investors, Banca Commerciale Italiana (Comit) and Credito Italiano (Credit) were born. These two credit institutions, innovatively created to operate both as commercial and investment banks, soon became the two major financial players in Italy, with a crucial role in the financing of new industrial initiatives and the expansion of the existing ones.

A crucial aspect of the business model of both Comit and Credit – imported from the German *Kreditbanken* and quickly mimicked by other Italian banks – was their attitude to operate as 'mixed banks', that is raising capital from the public in the form of sight deposits, while at the same time engaging in long-term financing for their industrial clients. This obviously created a risk of liquidity mismatch that the banks routinely managed by placing huge slices of debt in the bond market, and favouring their clients' access to the stock market while generally profiting from the underwriting process: this boosted the growth of the Italian stock markets even further (Nardozzi and Piluso, 2010). Over time, the 'mixed banks', and Comit in particular, found their portfolios crammed with the shares of their main corporate clients (Confalonieri 1975). In cases where the financial conditions of the clients were ailing, conversion of debt into equity was often the only solution available to restructure the exposure of the banks. These incestuous bank-firm relationships were bound to increase in the following years and play a critical role in the young Italian economic system and also affected corporate law reforms.

Early Proposals for the Reform of the 1882 Commercial Code (1882–1911)

In this context, the 1882 Commercial Code, although considered a milestone towards a more modern and efficient corporate environment, revealed its own shortcomings. For example, scholars have pointed out the light regulation of internal controls, as well as the minimal (if not loose) regime of directors' accountability: the financial statements of a listed company could be squeezed in the few lines of a one-page document (Padoa Schioppa 2010).

Voting rules, too, became a debated matter among businessmen, lawyers and law professors, as the shareholders' meetings of the Italian

major corporations were increasingly becoming the battlefield for financial raiders, and the voting limitations imposed by corporate charters, such as prudent-mean rules, were circumvented in several ways.

For example, a tool that attracted much concern from the 1890s was the use of so-called '*azioni al portatore*', i.e., bearer shares that circulated on a no-name basis. These shares, initially created to encourage private investment and the free circulation of small corporate shareholdings, became instrumental in by-passing the prudent-mean rule through the fractioning of a huge block of shares among a myriad of dummies. The halls where the shareholders' meetings took place were crowded with banks' employees, salesmen and, apparently, even 'servants and cooks', each claiming to vote its own small block of bearer shares, purchased from their principals just before the meeting and quickly re-transferred to the real beneficial owners just a few minutes after the meeting (Sraffa 1893). Several reform projects on this matter followed one another starting from 1891: some proposed that the prudent-mean rule become mandatory; others – opening a long-lasting debate that involved some of the most influential Italian jurists and economists until the 1920s – suggested stripping bearer shares of voting rights, or prohibiting the issue of such shares altogether (Padoa Schioppa 2010).

Repurchase agreements were also used as an instrument to convey voting rights in the imminence of a meeting, a technique which foreruns the more sophisticated securities lending in the 20th and 21st centuries, and that could be considered an early form of 'empty voting' (Hu and Black 2006). Thus, a reform bill of 1904 proposed to prevent 'repo' shares from voting, perhaps not considering that such prohibition could be easily eluded by entering into two seemingly unrelated sale agreements (Vivante 1905).

A more balanced solution was proposed in the first important reform project of the 20th century (the 'Fani-Luzzatti' project, named for the Minister of Justice and the Prime Minister who promoted it in 1910–11). According to this project, the voting rules of the 1882 Code were not touched, but bearer shares could vote only if deposited with the company's offices at least five days in advance of the meeting date. Perhaps, this would have also reduced the misuses of repurchase agreements.

Interestingly enough, not only scholars, but also business circles, such as some influential regional chambers of commerce and prominent executives (e.g., Marco Besso, the managing director of Assicurazioni Generali, a large insurance company) lobbied to strengthen the Code's rules on the shareholders' meetings and, more generally, favoured a reinforcement of the shareholders' franchise. In fact, businessmen found a common ground with supporters of 'corporate democracy', as the

tightening of the voting rules would have protected their corporations from unexpected raids and incursions from speculators. The empowerment of existing shareholders would help to keep the barbarians from the gates of the corporate citadel.

From World War I to the Advent of the Fascist Era (1915–25)

The 'honeymoon' between reformers and business constituencies was however short-lived, due to a series of events that changed the Italian economic and social landscape in the following few years.

In 1907 – no differently from what happened almost exactly a century later – Italy had imported from the U.S. a virulent financial crisis, which had dramatically hit the stock exchange (about 80 per cent of the overall capitalization vanished in few weeks), and spread quickly to the real economy, giving rise to a long-term monetary and credit crunch (Confalonieri 1982).

When Italy entered World War I (in 1915), the entire industrial production was bent to the needs of the military effort. The consequent huge demand for capital was satisfied by a massive intervention of the 'mixed banks' (again), through both credit lines and direct equity injections into all the important industrial players. This resulted in a consolidation of the 'dangerous liaisons' between banks and firms (Cabiati 1926; Cariello 2015). In addition, right after the Great War, some industrial groups used their excess liquidity to accumulate shares in the major Italian credit institutions. In a twist where the controlled corporations attempted to take over their own controllers, financial raids and ensuing entrenchment tactics began to run amok, adding to the instability of the stock markets (Nardozzi and Piluso 2010).

A simmering revulsion towards these manoeuvres spread into the public discussion, pushed by left-wing forces such as the Socialist Party and, from 1921, the newly established Communist Party, parties that had gained representation in the Italian Parliament. Two events sum up well the effects of the new political mood on the corporate law debate. In 1920, a statute was passed (and repealed three years' later) prohibiting the issuance and circulation of bearer shares, blamed for being a conduit for 'speculation'. In addition, for the first time in Italy, proposals for the creation of shares reserved for employees flourished (Padoa Schioppa 2010).

In fact, the 'reformist' proclivities of many law experts and scholars, who often happened to be members of Parliament and very careful about the political consequences of their proposals, faced the conservative reaction of new business lobbies such as *Assonime* (founded in 1910 and

bringing together business corporations) and *Confindustria* (the association of Italian entrepreneurs). This development is nicely captured by the so-called 'Vivante project', which deserves a brief discussion.

In 1919, upon the initiative of the Ministry of Justice, a commission for a comprehensive reform of the 1882 Commercial Code was set up. The commission was composed of the most prominent corporate law professors of the time and by some representatives of the business and professional circles. The chairman was Cesare Vivante, a scholar who had called for a reinforcement of the shareholder franchise against the managers' (and bankers') prevarications: and had also proposed a strict regulation of voting trusts and pyramidal groups, control-enhancing devices increasingly used by corporate insiders for entrenchment purposes, no different from what was happening, more or less at the same time, in the U.S.A. (Vivante 1923).

The output of the reform commission (a project issued in 1922) reflects several ideas of its chairperson. First, the project did not outlaw bearer shares, which – as Vivante repeatedly argued – may be regarded as a useful tool for raising capital from retail investors. Rather, the introduction of a sort of record date mechanism was proposed to cure the most criticized abuses: only holders of bearer shares registered three months in advance of each meeting were to be admitted to vote. As to voting rights, the prudent-mean rule was superseded by a default 'one share, one vote' principle, following the German experience. In addition, the proposal allowed the creation of preferred shares with voting rights essentially limited to the issue of new shares and charter amendments (Progetto preliminare 1922).

Indeed, on voting matters, the most important provision contained in the Vivante project was an outright prohibition of voting trusts and, more generally, of all agreements 'conditioning the freedom to vote' – voting pacts so common nowadays – which should have been deemed null and void. This proposal attracted fierce criticism from all the business and banking associations, which labelled the envisaged prohibition as being 'inspired by purely theoretical speculations', cut off 'from the real life', while voting trusts were overtly defended as 'one of the few truly effective actions' against takeovers and speculation (Confindustria 1925).

The negative reaction against the prohibition against voting trusts overshadowed a series of other modern and well-balanced proposals included in the project, often inspired by the profound comparative perspective of Professor Vivante. The document, for example, suggested the introduction of derivative suits against the directors in breach of their fiduciary duties, and the creation of a new type of business organization akin to a limited liability company (Progetto preliminare 1922).

Eventually, the project was rejected by the legislature. It may be surprising that this happened at the very outset of the fascist regime, considering that Benito Mussolini and his followers had been initially supportive of anti-capitalist ideals. To be sure, the newly appointed Prime Minister, as soon as he grabbed power, was keen on gaining the approval of the largest banking and industrial groups to consolidate his position. A 'shareholder-friendly' legislative initiative was an easy sacrifice for the opportunistic *Duce*.

Interestingly, the Vivante project would remain a milestone and a source of inspiration in the years to come. To highlight just a few examples, the proposal of a limited liability company for small enterprises was later implemented in the 1942 Civil Code; the derivative action was proposed again in the 1950s and later gradually adopted from 1998; and even the idea of a prohibition of voting agreements was discussed again in the 1990s, when a general regulation of shareholders' agreement in listed companies was adopted for the first time.

The reform process did not stop with the wreck of the Vivante project. In 1923, the Government formed a new commission (chaired by Mariano D'Amelio, the Supreme Court Chief Justice) that – although it included many of the law professors (including Vivante) who had taken part in the previous commission – was more heavily influenced by the business lobbies (especially *Confindustria*). A further reform project was published in 1925.

The 'D'Amelio project' overtly marks its distance from a time of 'suspicion against corporations' (D'Amelio et al. 1925). That this wink to the business and finance establishment was no lip service, it was in fact confirmed by the contents of the project. Focusing only on issues related to the core of this contribution, the new proposal contained no restrictions with respect to voting rights of bearer shares. In addition, to stabilizing corporate control, it recognized that shareholders could contractually grant to third parties their corporate rights, although within a maximum four-year term (sanctioning the validity of most shareholders' agreements). Also, a 'one share, one vote' principle was adopted as a default rule, but 'limited voting shares' could be created for investors interested in a preferred dividend without active participation in the life of the corporation: this dual-class structure allowed capital to be raised without diluting the power of control groups.

The reform project resisted, however, some of the requests advanced by *Assonime* and *Confidustria*. In particular, the D'Amelio commission supported the prohibition of multiple voting shares, an issue that – as we will see in the next paragraph – had become the subject for a heated discussion among scholars, policy makers and business representatives.

The conservative approach taken by the commissioners on this single topic was strongly criticized – even from within the Government – by the supporters of the stability of corporate control against hostile acquisitions, favourable to greater flexibility in the creation and adoption of defensive measures (Padoa Schioppa, 2010).

Under these attacks, and possibly because it was a compromise that satisfied few constituencies, the D'Amelio project also was not able to lead to a legislative reform.

A Deep Dive into the Italian Corporate Law Debate Between the Two World Wars: the 'Battle' over the Multiple Voting Shares

As mentioned, the prudent-mean rule set forth by the 1882 Commercial Code was a default rule. On its face, the Code did not limit the shareholders' creativity in devising different degrees of correlation between economic investment and voting rights. The only express prohibition was the issuance of non-voting shares.

When, at the beginning of the 20th century, multiple voting shares (MVS) started appearing in a number of Italian corporate charters, scholars and courts were taken by surprise. In fact, the law did not mention MVS, but this likely occurred because, a few decades' earlier, when the Code was elaborated, this powerful control-enhancing device was virtually unknown in Italy (Cariello 2015). No one could have expected that MVS would have quickly become the most debated corporate law issue in a crucial phase of the Italian economic development.

To understand how this happened, we need to recreate the scenario that the major Italian corporations faced at end of the Great War. No differently from many other European countries, the transition from a war economy to a normalized manufacturing production was accompanied by a monetary expansion and, with it, by a rampant inflation and a strong currency devaluation (Nardozzi and Piluso 2010). Consequently, while liquidity flowed to the economy, at the same time the public companies became vulnerable to incursions and raids from abroad. This obviously alarmed the controlling groups (Asquini 1961).

Along with the foreign threat, a domestic factor came soon into play. Over time, the investments of the 'mixed' banks into the capital of the primary important manufactory players (see above) had continuously increased in size and had reached a danger level. Suffice to say that, in 1931, Comit alone owned more than 25 per cent of the shares of all Italian public corporations (Toniolo 1978; Cariello 2015). In the eyes of most Italian entrepreneurs in the 1920s, this lumbering presence constituted a worrying menace to their control powers, which needed to be

halted. Multiplying the voting power associated with the control stakes seemed the easiest way to erect a protective barrier against external and domestic attacks.

The recent experience from other jurisdictions offered more than a cue. In 1903, the French lawmakers had expressly introduced MVS in the *Code de commerce* and, by the early 1910s, many companies (including some banks) had implemented this mechanism in their charters (Frè 1925). Germany experienced a real boom in the use of MVS, which was expressly allowed by the *Handelgesetzbuch* from 1897. During the Weimar Republic, MVS were increasingly adopted as an instrument to ensure that, while the German public companies opened their capital to U.S. investors, the control be kept in domestic hands (Cariello 2015). To exploit this mechanism during the hyperinflation period in the 1920s, some charters went as far as to grant 40 votes per share (Frè 1926).

On the French and German wave, and levering on the ambiguous silence of the Commercial Code, also the Italian corporate counsels started advising their clients (both industrial corporations and financial institutions) to create classes of shares with multiple voting rights, at least with respect to resolutions concerning the board appointment and the financial statements approval. In 1924–25 alone, approximately 40 companies issued two million MVS, with multiplying ratios usually ranging from five to 10 votes per share, but exceptionally jumping up to 50 votes per share (Cariello 2015).

Needless to say, the Italian sponsors of MVS did not emphasize the entrenchment effects of their device. Rather, to present MVS under a favourable light, they used the argument of the 'foreign threat' (Scialoja 1925). They also tried to demonstrate that the irrational and apathetic attitude of most retail investors pushed them into the hands of raiders and speculators, thus undermining the monitoring function of the shareholders' meeting. On this view, MVS were necessary to concentrate the voting power in the hands of those investors actually interested in the long-term growth of their company. Interestingly, this argument – which echoes, in some respects, the discussion on the separation between ownership and control famously depicted, a few years' later, by Berle and Means (1932) – was defended, among others, by Cesare Vivante, certainly not suspected of being too sympathetic with the business establishment of the time (Vivante 1925). In fact, this author believed that MVS were a control-enhancing device more transparent and less problematic than the shareholders' agreements.

Furthermore, the advent of the Fascist regime paved the way to an ideological approach to the MVS issue (Cariello 2015). A corporation with MVS – it was argued – is an organization where the purely financial

investors are subject to the intellectual and decisional power of those who are more skilled in terms of technical capabilities (Scialoja 1925). In other words, the decision-making power should not be allocated to the shareholders on the basis of the capital they have invested in the company, but in accordance with criteria of managerial leadership. Of course, such an 'aristocratic' view of corporate governance – which, indeed, implies the affirmation of a *Führerprinzip* – reveals a disquieting parallel with the crisis of political democracy then being undergone in Italy and in several other European countries.

Despite the politically unfavourable environment, some professors of law and economists vigorously resisted the dominant view. Some described MVS as a legal device aimed at ensuring perpetuity and irresponsibility of directors, as well as practically abolishing the shareholders' meeting (Frè 1926). Others warned about the adverse effects that a massive recourse to MVS would have on the retail investors. Luigi Einaudi, an economist who courageously defended liberalism during the Fascist era, voiced his opposition to such a stark deviation from the proportionality between economic investment and vote, and defined MVS as 'a devil's invention precisely aimed at putting retail investors to flight' (Einaudi 1932). Similar arguments were extensively developed by Attilio Cabiati, another economist, in a vibrant debate with Vivante, who supported MVS (Cabiati 1926). Finally, Lorenzo Mossa, a prominent law professor (initially not distant from the Fascist intelligentsia), concisely labelled MVS as 'a real social plague' (Mossa 1927).

The 'battle' over MVS reached its acme, in 1924, when the Court of Milan refused to 'homologate' the introduction of a class of MVS in Comofin, a corporate vehicle that controlled Comit, the first Italian bank – recall that, at the time, all amendments to the share structure of a corporation had to be upheld by a court. The timing of the Comofin decision was not coincidental. In 1924 Comofin (and, indirectly, Comit) was under the threat of a takeover organized by Mario and Pio Perrone, two brothers owning a controlling stake of Ansaldo, a leading producer of iron and steel. Comofin moved in defence of its main asset (Comit) and issued MVS to be allocated in the safe hands of 'loyal' shareholders close to Jósef Leopold Toeplitz, the influential CEO of Comit (Cariello 2015).

It may seem curious that the primary 'mixed bank' was trying to protect itself from the attack of an industrial player, given that – so far – we have discussed about banks attempting to taking control of manufacturing corporations. However, as mentioned above, massive purchases of banks' shares were a type of counter-reaction that corporations put in place to thwart the banks' attacks.

The litigation continued, with Comofin appealing the decision by the Court of Milan and the Perrone brothers counter-appealing. The judgment was reversed by the Court of Appeals with a decision later confirmed by the Supreme Court in 1926. In its opinion, consistent with the line of reasoning most shared in the business circles, the Supreme Court stuck to the black letter of the Code – no express prohibition of MVS – and labelled the criticism against this device as 'moral and economic rather than legal'.

One might ask why, eventually, MVS did not make their way through the various reform projects discussed in the 1920s–40s. Most likely, the answer is that, a few years after the Supreme Court decision on the Perrone-Comit case, the political interest for MVS declined rapidly. With the crisis of the 'mixed bank' model after 1929 and the nationalization of many Italian corporations (see next section), the market for corporate control was more than downsized. Obviously, with the potential targets under state control, hostile takeovers ceased to be at the top of the regime's agenda.

Towards the New Civil Code (1926–42)

A few years after the D'Amelio project, Italy suffered the turmoil of the 1929 crisis and its aftermath. The Fascist regime, which in the meantime had consolidated its power into a highly active, murderous dictatorship, reacted to the collapse of all the major Italian banks with bailouts and nationalizations. The 1936 Banking Law – somehow along the lines of the 1933 Glass-Steagall Act in the U.S. – sanctioned the separation between 'ordinary lending' and 'special lending' (i.e., investment banking) and prohibited banks from exercising both activities (Costi 2012). A long era of bank–firm intermingling came to an end, superseded by rigid state control on the financing of corporations.

During the same period, while many national industrial champions, especially in the energy and telecommunications sectors, were nationalized under the 'IRI' (Institute for Industrial Reconstruction), the legislation on Italian medium–large corporations witnessed an increase of restrictions and public controls that, in some respects, took the country back to the 19th century. In 1935, for example, the requirement for governmental authorization of new incorporations was reinstated, at least in some cases, and even issuing of new shares or bonds came under government supervision. Other legislative interventions positively modernized internal controls: for instance, professional and independence requirements were introduced for statutory auditors, in order to improve the quality of their control activity and reduce conflicts of interests, and

more rigid accounting principles were set forth, in line with the standards adopted in other European jurisdictions.

Nevertheless, these were isolated measures, implemented outside the framework of a comprehensive corporate law reform, which was opposed by business interest groups.

The initiatives for a more profound reform of the Commercial Code were resumed only in 1939. In the area of corporate law, the so-called 'Asquini project' – as usual, from the name of the commission's chairman – drew on many provisions of the 1925 D'Amelio draft, following in the footsteps of the German *Aktiengesetz* of 1937 with a strong commitment to stable control and perpetuation of the existing controlling groups' power, under a regime of state controls. Whether this approach was inspired by a genuine belief in the importance of facilitating a long-term view of business activities, or was motivated to appease economic interests supporting the totalitarian regimes, is hard to determine: probably both.

Several control-enhancing mechanisms already envisaged in the previous project were transposed into the text of the new one: for example, it was confirmed that shareholders' agreements with a duration not exceeding five years were valid, binding and enforceable. Other provisions came to support directors' entrenchment. For example, the draft legislation allowed corporate bylaws to condition the transfer of non-bearer shares upon the agreement of the board. It was even proposed that the shareholders' meeting elect only a majority of the board members, with the remaining seats assigned to the candidates appointed by the newly-elected directors. Paradoxically, this would have been a decided step in the direction of a managerial type of capitalism that has shown its limitations with the current proxy access debate in the U.S. (Ventoruzzo 2011).

With respect to the shareholders' franchise, the idea of limited voting shares was put forward again. On the other hand, the prohibition of multiple voting shares already contained in the D'Amelio project was confirmed, with the only exception of corporations operating in strategic sectors, where 'golden shares' could be used to enhance the position of controlling governmental entities.

In 1940, the Asquini project was quickly inserted, with a few amendments, into a larger project for a new 'unified' Italian civil code, eventually approved in early 1942. Italy had in fact decided to no longer have a civil code separated from the commercial code, but to unify these two statutes in one single, integrated Civil Code, a quite original solution in the European scenario. In the 'unification' process, principles of

commercial law, traditionally reserved to business transactions, percolated also to other contracts and legal relationships (Rondinone 2003).

To be sure, the idea of a single civil code was not new: it had been voiced by Cesare Vivante decades earlier (Vivante 1888). However, at the apex of the Fascist regime, the choice of consolidation was especially driven by the political ambition to provide a comprehensive regulation of all civil relationships – including family, contract, labour and corporate matters – within the framework of the 'corporative' system, in deliberate contrast with the individualistic and 'bourgeois' stance of the French model that had inspired Italian private law thus far. This view reflected the ideology of the dictatorship, which strived to reduce conflicts among social classes through the creation of state-controlled social organizations (i.e., guilds, or 'corporations') called to harmonize their divergent interests and cooperate to the realization of the supreme interest of the totalitarian state. Under the disguise of 'social peace', the regime realized a top-down control over the entire economic and social system. The core principles of the corporative state were expressed in the 'Labour Charter' of 1927, entirely transposed into the new Civil Code.

This political mind-set also penetrated, to some extent, the corporate law rules contained in the Code. The corporative view inspired the cancellation of certain 'board-centric' measures envisaged by the Asquini project (such as the 'co-optation' of the directors referred to above), and an extension of public interference in the internal affairs of the corporation, for example attributing to public prosecutors the power to report in court censorable directors' actions. More generally, private autonomy was curtailed.

VOTING RIGHTS AND CLASSES OF SHARES UNDER ITALIAN LAW FROM THE 1942 CIVIL CODE TO TODAY

As mentioned above, for roughly 30 years after the end of World War II, Italian corporate law remained fairly stable with respect to the regulation of classes of shares and voting rights. In addition to full voting shares, corporations could issue limited voting shares allowing voting only on charter amendments and other extraordinary transactions, provided that these shareholders enjoyed a privilege in the distribution of dividends.

From 1959, a commission instituted within the Ministry of Industry started working on a reform of corporate law, with a focus on establishing a set of special rules applicable to listed companies only (Acerbi

2010). In this context, the rigidity of the civil code's approach on the creation of classes of shares with special rights was called into question. The prevailing idea was to offer incentives for small investors, not interested in actively participating in the governance of corporations, but attracted by strong economic rights. Hence the proposal of special shares called '*azioni di risparmio*' (saving shares), that could only be issued by listed corporation and had to be admitted on a regulated market. Such shares would be equipped with a dividend privilege, but with no voting rights.

The saving shares idea represented the search for a difficult compromise between creating incentives for retail investment in Italian corporations – as proposed by the policy makers supportive of an Anglo-Saxon model of a public company – and avoiding dilution of the existing controlling shareholders – as Confindustria and other business associations feared. On the one hand, the owners of saving shares were outside the shareholders' meeting and any meaningful influence on the company's management was neutralized: in fact, the ideal of a 'corporate democracy' was set aside. On the other hand, the expansion of the Italian stock market was encouraged, although through legal instruments that were focused on attracting retail investors and not yet attentive to the opportunities coming from the participation of institutional investors to Italian listed companies (Marchetti 2010).

After years of discussion – and several reform projects – Law No. 216 of 1974 introduced saving shares, within a broader reform that also included the creation of the Italian Stock Exchange Commission. The law specified, quite precisely, the minimum privileges that had to be attached to these securities, in terms of both an additional dividend vis-à-vis the one paid to full-voting (or 'ordinary') shares, and residual rights in case of liquidation of the corporation. To analytically discuss how the economic rights were shaped would be beside the point here. Suffice to say that the payment of additional dividends was not guaranteed, but rather mandated if and when the corporation wanted to pay dividends to shareholders. Saving shares had no voting rights on any issue. However, pursuant to a general rule of the Civil Code, applicable also to limited-voting shares (Article 2376) and still in force today, a resolution of the general shareholders' meeting that could adversely affect shares of different classes, for example reducing the economic privilege, need to also be approved by a 'special' meeting limited to the holders of the shares whose rights were modified.

Leaving aside the technicalities, what is interesting to consider is the general idea behind this legal innovation, the idea that it was possible to optimize the financial structure of a corporation, and in particular reduce

the cost of capital, by offering shares tailored to the specific (perceived) preferences of two types of shareholders: more active ones, interested in participating in the life of the corporation by appointing directors, taking part in the major decisions, and so on; and passive retail investors only interested in collecting dividends (sometimes called, in Italian, '*cassettisti*', an expression that loosely translates as 'drawer-holders', in the sense that they keep their shares closed in a drawer).

This idea proved not very effective. As expected, saving shares always traded at a significant discount when compared to full-voting shares, but in fact the discount was often more significant than their supports would have predicted. This was obviously even clearer in periods of mergers and acquisitions, when non-voting shares, irrelevant to control the corporation, were left out in the cold and did not enjoy capital gains. In addition, the rigid mandatory rules concerning how to calculate mandatory economic rights, originally possibly intended to protect small and unsophisticated investors, did not allow moulding the securities in accordance with the specific features of the issuer, evolving market scenarios, and investors' preferences. One size, in brief, does not fit all.

In the 1990s, in fact, neither corporations nor investors seemed too fond of saving shares, and the legislature started tinkering with the rules. In 1998, with the introduction of the so-called '*Testo Unico della Finanza*' (Consolidated Law on Financial Markets), policy makers took the occasion to partially liberalize '*azioni di risparmio*'. In particular, in line with a growing tendency to grant more contractual freedom to bylaws (something to which we will return), the definition of the specific, additional economic rights that non-voting shares were entitled to enjoy was largely left to private ordering, with the idea that issuers were better positioned than the legislature to fine-tune the rights and obligations of investors.

This mini-reform of saving shares was however followed by a more complete overhaul of the Civil Code approach to classes of shares on the occasion of a sweeping corporate law reform that entered into force in 2003. This reform was clearly aimed at enhancing contractual freedom, and showed a significant trust in the ability of the market to achieve efficient and effective solutions. Both for closely-held and listed corporations, the system became more flexible, the scope of mandatory rules was reduced and the relevance of default, enabling rules was broadened. Just to give an example, three different corporate governance systems were made available, and corporations could opt, in their bylaws, for one of them. Of course, the increased contractual freedom was compensated by new and stronger protections for minorities, for example appraisal rights were reinforced both introducing new and broader triggering

events, and adopting more favourable rules to evaluate the shares of dissenting investors that opted to be cashed out.

One of the areas in which this liberalization was very notable was in the financial structure of the corporation. As an example, several pre-existing limitations to the issuance of bonds were lifted. The rules applicable to classes of shares, in particular, were profoundly changed.

As we have discussed, immediately before the 2003 reform a corporation had the possibility to, basically, issue three categories of shares. Full-voting shares, also called 'ordinary' shares, but basically entitled the holder to dividends depending only if and to the extent which directors and shareholders approved a distribution; limited-voting shares were not entitled to appoint directors and vote on the other matters reserved to the 'ordinary' shareholders' meeting, but had some economic privileges; and – only for listed corporations – saving shares with no voting rights and theoretically stronger economic privileges.

Most of these limitations disappeared with the reform. New Article 2351 of the Civil Code, in fact, allowed the issuance of non-voting shares in all corporations, including non-listed ones. In addition, while previously the only type of limitation to voting rights possible was to exclude the right to vote in the ordinary meeting – i.e., voting would be restricted to amendments of the corporate contract, but it was not possible to specific select specific issues on which shares could vote – pursuant to the new provisions corporations can cherry-pick the matters on which a class of shares can vote. For example, a class of shares can be created with voting rights on appointment and removal of directors, but not on financial statements and dividends (all within the competence of the ordinary shareholders' meeting): *and* on mergers, but not on issuance of new shares generally or other amendments to the bylaws (within the competence of the extraordinary shareholders' meeting) (Ventoruzzo 2004).

The reform also clarified that voting rights – on any particular matter – can be conditioned to the occurrence of specific events: to exemplify, you can issue a particular category of shares with no or limited voting rights, which however obtains full voting rights if certain targets in terms of profitability and financial stability are not met. New Article 2351 also 'rediscovered' the old default rule adopted by the 1882 Commercial Code, setting forth that closely-held corporations can also provide prudent-mean voting systems in which the votes of a single shareholder could be capped independently from the number of shares owned.

Clearly, the 1942 approach was revolutionized by these rules, and the flexibility did not end there. In 2003 also new non-equity financial instruments were regulated, instruments that – contrary to previous

limitations – could also vote on some crucial corporate governance issues, for example appointing a member of the board of directors.

Basically, the only noteworthy limitations that remained standing were the fact that limited voting shares could not exceed 50 per cent of the capital, in order to curb the leverage that controlling shareholders could exploit, and the prohibition – a sort of 'taboo' of Italian corporate law since the 1940s – to issue multiple voting shares.

From an economic and legal perspective, allowing limited voting shares, especially with the briefly described degree of liberty, and prohibiting multiple voting shares, cannot be easily defended. Needless to say, they are two sides of the same coin, and the possibility of creating categories of shares with different administrative powers can have similar effects either issuing limited or non-voting shares, or issuing multiple voting shares. In addition to a certain path-dependency and the well-known inertia of legal systems, the resistance against multiple voting shares was linked to the idea that practically they would have created even more profound differences between the 'haves' and 'have-nots' of the business world, and allowed too extreme a separation of ownership and control.

But this taboo also crumbled in 2014, when the Government introduced a bill designed with the goal of creating more incentives for corporations to go public, basically facilitating the issuance of new shares without losing control (Ventoruzzo 2015).

In short, Law No. 116 of 2014 introduced two new types of multiple voting shares. Closely-held corporations can issue shares with up to three votes per share. The rule mandating that not more than 50 per cent of the equity should be represented by limited voting shares has not been abolished, but thanks to the new provisions, with a careful use of limited voting shares and treble-voting shares, a shareholder could have absolute control with as little as roughly 12.5 per cent of the capital (previously, one needed to own at least 25 per cent).

In listed corporations, multiple voting shares are not possible, but the mini-reform of 2014 opened the door to so-called loyalty-shares. Based on an amendment of the previously mentioned Consolidated Law on Financial Markets originally introduced in 1998, bylaws can include a clause granting double voting rights to any beneficial owner holding the shares for a minimum period of two consecutive years, a privilege lost where the shares are transferred.

Needless to say, the new provisions raise several technical questions and their interpretation is not entirely settled yet. More interesting than the specific details, in the perspective of this contribution, it is to briefly consider possible motivations and reactions to the reform.

Multiple and limited voting shares have traditionally prompted a very lively, and occasionally heated discussion in most legal systems. Supporters of 'corporate democracy' stigmatize them as yet another control-enhancing device that can be used to entrench large shareholders and managers, at the expense of minority investors. Institutional investors frequently oppose them strongly, and in Italy some of them have also initiated a campaign aimed at blocking the new law and, once it had been passed, to convince incumbents not to use this tool. While some of these criticisms are undoubtedly grounded, the reality is that the available empirical evidence on the effects of multiple voting shares is, at best, inconclusive, and in any case the answer would vary depending on several variables, including the industry in which the corporation operates. Multiple voting shares pose some risks for minority investors, and might hinder the market for corporate control, but this characteristic is shared by plenty of other available legal instruments, from shareholders' agreements to pyramidal structures. Perfect proportionality between investment and voting rights does not exist, as mentioned, in any legal system, and would probably be both undesirable and impossible to achieve.

The Government probably resolved to adopt these new instruments in the belief that corporate law should be flexible, and that as long as disclosure is guaranteed, market forces are better equipped to self-regulate, and determine the fate and success of multiple voting and loyalty shares. Rather than an outright prohibition, the legislature preferred to lightly regulate the phenomenon, leaving contractual freedom and the law of supply and demand to shape the financial structure of corporations. Interestingly, at least so far (roughly three years after the introduction of multiple voting shares), few corporations have either adopted multiple voting shares, or flirted with it, possibly also due to the pressure of institutional investors.

One of the catalysts of the legislative innovation has probably also been regulatory competition especially among European states. While very different from the market for charters in the U.S., in the last 15 years greater mobility of corporations in Europe, due also to some precedents of the European Court of Justice that has liberalized forum shopping, has clearly allowed corporations to incorporate more freely in one jurisdiction while doing business in another one. It cannot be considered coincidental, in this respect, that just a few months before the adoption of the new law, Fiat-Chrysler, one of the most important Italian multinational corporations, and a world leader in car manufacturing, had reincorporated from Italy to the Netherlands, apparently also to take

advantage of the possibility to issue multiple voting shares, allowed by Dutch law (Ventoruzzo 2015).

CONCLUSIONS

While history never exactly repeats itself, it is sometimes inevitable to notice recurring patterns. Considering the development of classes of shares with different voting rights, the pendulum oscillates between flexibility and contractual freedom, on the one hand, and mandatory rules and rigid prohibitions, on the other.

Until the end of the 19th century, when incorporating required a special, ad hoc approval from policy makers, corporate law was not standardized (in fact, very few general rules existed on the subject matter), and the adoption of a broad spectrum of different solutions was possible and to some extent inevitable. In this context, voting rights were often disjoined from investment and, at least formally, corporations were more ‘democratic’. Each shareholder, independently from the number of shares owned, enjoyed one vote. Practically speaking, however, to characterize that period as a Golden Age of corporate democracy would be questionable. This not only because access to the corporate form was strictly limited to the wealthy and powerful, or because favouritism and nepotism were rampant, but also because corporate charters often found other ways to alter the default rule and the balance among shareholders.

With the diffusion of general corporation laws, the ‘one-share, one-vote’ principle became more widespread, at least as a default rule. In comparison to ‘one-shareholder, one-vote’, this development can be considered a victory of a plutocratic and capitalistic approach. In some jurisdictions, however, the rule was mitigated with ‘prudent-mean’ limitations, a sort of middle ground between the two opposing principles. In any case, the degree of standardization and the level of detail of corporate laws was still limited, and private ordering developed alternative voting structures.

Focusing on Italy, the 1942 Civil Code introduced a fairly rigid system, under which departure from one-share, one-vote was possible, but partially limited. In the last few decades, however, competition among European jurisdictions, circulation of legal models internationally, and also a growing faith in market efficiency and the ability of contractual freedom to adopt the most efficient solution – only partially justified by more rigid provisions on corporate disclosure and the development of institutional investors – lead however to greater flexibility, eventually eliminating the taboo against multiple voting shares.

According to Italian financial folklore, a famous Italian banker once remarked that 'Shares should be weighted, not counted', meaning that true corporate power does not simply depends on the investment made, but also on other factors. The copyright of this sentence is disputed: some attribute it to Enrico Cuccia (1907–2000), the legendary founder and head of Mediobanca – the first Italian investment bank; others to Donato Menichella (1896–1984), director of IRI first and later Governor of the Italian Central Bank. But also the meaning of the statement is ambiguous: in a more sinister perspective, it evokes undue influence, back-door deals, political connections; in a more positive one, it might suggest that economic influence reflects intelligence, skills, hard work, strength and charisma; more than simply deep pockets. Whatever might be the correct interpretation, the law has rarely entirely prevented a divergence between cash flow rights and voting rights.

This 'wedge' has broadened and narrowed across history, in a battlefield of ideas and interests that juxtaposed supporters of free markets and of regulated economy, managers and controlling shareholders and minority investors, reformers and conservatives. Even if through a peculiar and occasionally tormented history Italy, no differently from other systems, has evolved towards more rigid, mandatory rules aimed at fostering that peculiar type of plutocratic democracy that the modern business corporation is, with a peak of this movement with the adoption of the Civil Code of 1942; but from the 1970s on has shown a greater reliance on regulatory competition and private ordering in which the excessive power of the corporate insider should be counterbalanced by efficient financial markets and savvy institutional investors.

The next few years will tell us if the pendulum has reached its most extreme position, and is ready to swing back.

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11. A history of the corporation in Spain in the twentieth century: towards Europe

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1. INTRODUCTION

On several occasions, Spain has adopted ground-breaking decisions on legislation that have not been echoed in its sparse economic development. The history of the corporation provides some examples that can help us better understand the complex relationship between institutions, legislation and economic development. This chapter analyses the evolution of the corporation as a legal form in Spain from a historical perspective, rather than detailing modifications to the articles of its different laws. The primary goal of this chapter is to fully understand the historical process behind the changes to Spain's laws and and how that process drove the legislature to make certain decisions.

Within the framework of the capitalist economy, researchers have paid particular attention to the analysis of corporate law, since its development has been linked to the industrialization process (Harris, 2000). All Western countries at some point in their process of economic and social modernization have changed their corporate law. Over time, older laws gave way to modern, more flexible and liberal corporate legislation which would have the power to create new industries and foster entrepreneurship. This mystique around the concept of the corporation persists to some extent. Influential authors, like Chandler, have achieved great influence by identifying the corporation as a precursor of modernization and economic change (Chandler, 1977). Relevant organizations in today's economy, such as the International Monetary Fund and the World Bank, strongly recommend strengthening the corporate legal form in preference to other legal forms for businesses. The arguments of these influential

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organizations are also supported by in-depth studies into the aforementioned ideas. La Porta, Lopez-de-Silanes and Shleifer's 2008 article is one of the most significant pieces of corporate governance-related literature today (La Porta et al, 2008). It has had a major impact and sparked a wave of literature emphasizing, once again, the idea of the corporation as a superior business organization. These authors have also noted that today the countries with the largest equity and debt markets are those with code-based legal systems, suggesting the superiority of common law legal environment for meeting the needs of the economy and entrepreneurs. Scholars, even so, have pointed out that recent studies on the subject indicate that the corporation has been overstated as the cornerstone of economic growth, and some scholars have attempted to refocus the literature on the nuances of laws governing organizational choices in business (Nicholas, 2015, 333). Guinnane et al. have provided evidence of the complexity of the menu of business organizational choices, and the diversity of the corporation itself (Guinnane et al, 2007; Guinnane et al, 2017; Lamoreaux, 2016). Unravelling the complexities of the evolution of the corporation requires then an understanding of the particular historical context which gave rise to this legal form. This means going beyond the stereotypical facts that characterize the corporation (e.g., that capital is divided into shares, or their owners can transfer shares without incurring any risk other than the part of acquired capital). The successful implementation of the corporation, meaning the spread of its use, requires a certain degree of economic development, but also the social and political recognition of individual freedoms and rights of association. Most Western countries that successfully adopted the corporation during the second half of the nineteenth century embraced a system in which anyone who met certain legal requirements could form a corporation. These requirements included registration so that the public could obtain information about the activities and economic status of the corporation.

Spain participated early in what some authors call 'Open Access' to the corporation (Lamoreaux, 2016; Lamoreaux and Wallis, 2006). In its first Commercial Code (1829) the Spanish legislature defined the corporation (*sociedad anónima* or *SA*), following France's lead, and allowed anyone who met a given set of legal requirements (particularly registration) to form a corporation**.** Later in the century, however, the legislature shifted back (again) to a concession system, which required the explicit authorization of the monarch to form a corporation.

The desire to move closer to Europe drove legal changes in the twentieth century. The history of company law in Spain in that century is surprisingly short: throughout the years, the different governments only

passed two laws on corporate law, both in the second half of the century. Considering that during that century Spain had two dictatorships, two parliamentary democracies, and one republic, it seems that the attention received by the corporation was low. Two facts explain this apparent 'legislative apathy'. The first is Spain's limited economic development during the first half of the twentieth century. Scholars point out that most of the growth of corporations in Spain occurred in the latter half of the century (Carreras and Tafunell, 1993). The second has to do with the flexibility of Spain's existing company law, its Commercial Code (1885). The few requirements for establishing a corporation and the scarce regulations regarding corporation management did not seem to bother business persons. On the contrary, these entrepreneurs seemed to feel comfortable with the limited requirements in the Commercial Code for creating a corporation. Business leaders may have opposed innovation because they were aware that no legislative change would be as favourable to them as the code of 1885.

Spain has had the same commercial code since 1885, in spite of many proposals for change that were put forward over the years. Ever since it was approved, members of Parliament have described the code as unambitious and blinkered. However, its longevity saw its flaws turn into strengths, and with time it was acknowledged that its drafters had provided it with resilience and the ability to adapt to change. The sparse provisions of the code (only 18 articles) were exclusive to Spanish corporations until 1951. Spain's integration into the European Economic Community (EEC) in 1986 required substantial changes in the regulatory framework. The European Union established the need for better law-making for the harmonization of corporations. Therefore, in 2010 Spain passed a new Corporation Law that regulated both corporations and private limited liability companies (PLLCs) under the same act.

When documenting Spanish history, many scholars in the field have looked closely at the relationship between institutions, development and legislation.[2] In the field of economic history, some recent works have also emphasized the same relationship. The bibliography at the end of this study provides an extensive, albeit far from exhaustive, list of these studies. The present work is part of a larger project carried out in recent years by Guinanne and Martínez-Rodríguez. The study follows the lead of other international investigations into the evolution and adaptation of corporation law in particular historical contexts, and the characteristics of a successful organizational menu for business enterprises. Within a more

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[2] A seminal study for Spain on this complex topic is Tortella (1968).

general framework, the essential questions that guide research in this area aim to answer a fundamental question: how does the impact of legislation, as an institution driven by a political and economic power, contribute to economic development?

2. PRECEDENTS, BACKGROUND AND BURDENS FROM THE PAST

The first Spanish Commercial Code (1829) was deeply influenced by the French Commercial Code (1807) (Tomás y Valiente, 1983, 510; Rubio, 1950). The section of the 1829 code addressing mercantile societies contained, however, some original innovations. The most notable of these required that all business enterprises regardless of their legal type be registered and all their documents be made public (Girón, 1951, 1323). In 1829, then, the Spanish corporation was the most modern in Europe. Everywhere else in Europe, business persons required specific and idiosyncratic authorization from the state to organize a corporation, while in Spain corporations had only to fulfil a minimal set of legal requirements. Any man (women's freedom was more limited) had the right to register a corporation, regardless of his age, status or wealth. (The only exception was the 'corporation with privileges', the approval of which depended on a Royal Decree signed by the Monarch (art. 294, Commercial Code, 1829).) This innovation had no precedent either in Spain or in other European countries. Even in France, which was a clear legislative flag-bearer for the continent, the formation of joint-stock companies was subject to direct government permission and detailed regulations prescribed by the (Public) Administration (art. 37, Commercial Code, 1829). Very few countries had enjoyed free incorporation before then, though it was available in New York in 1820, with other U.S. states following later (Lamoreaux and Wallis, 2016). Another innovation in Spain's code was that a partnership could avoid 'untimely dissolution' on the death of one of the partners (art. 329.3, Commercial Code, 1829). In the absence of explicit agreements among the partners in the articles of association, the default rule was that if an owner died, the partnership ordinarily wound up. Spanish partners of a regular partnership could, though, establish in the articles of association that after a partner passed away the firm would continue. Yet another innovation was that a regular partnership could have a limited partner (art. 274, Commercial Code, 1829) or an 'industrial partner' (art. 316, Commercial Code, 1829) among its members. Including a limited partner in a regular partnership meant that she could restrain her liability to her investment. However, in return, that partner

could not participate in management. The industrial partner contributed labour rather than capital to the firm, and earned a salary rather than a share of the profits. Like a limited partner, the industrial partner enjoyed limited liability for the firm's obligations, but could not participate in management.

Another sign of the modernity in the 1829 code was the principle of public access to official records and documents. Relevant information of all firms registered was made available to the public. Registration and publicity were mechanisms for controlling the veracity of the information provided by the owners of the firm. Each business firm had to be correctly identified in the register of the corresponding province (art. 290, Commercial Code, 1829). All the information provided had to be notarized. The code gave broad powers to the Courts of Commerce (an institution inspired by their French equivalent) to monitor and control the establishment and operation of corporations (art. 293 and 295, Commercial Code, 1829).

Despite the liberal gesture of the Commercial Code and the opportunities it offered to economic development, the country's reality was far from a climate of economic effervescence. Until 1834, the guild system was in force. Its abolition provided an impetus for the formation of firms (Law of Industrial Freedom (*Ley de Libertad Industrial*), 20 January 1834). In 1833, after the death of Ferdinand VII a dynastic and civil war began, with peace only re-instated in the early 1840s. The queen regent gained support for her daughter – the young Isabel II – in exchange for a liberal regime (based on the principles of freedom, private property, national sovereignty and parliamentary monarchy). The new laws had not served as a stimulus for entrepreneurs or for a cohesive internal market, due to the lack of a minimal banking network and basic road infrastructure. On Friday, 28 February 1848 (Law of 28 January 1848 and Regulation of 17 February 1848) the government suspended the regulations applied to corporations (that is, the Commercial Code of 1829) (Ansón, 2016). Spain had undergone an economic crisis in 1845, which the government blamed on a speculative bubble and subsequent collapse at the Madrid Stock Market. The solution was to cut freedom to create any kind of firm with capital divided into shares (corporations and limited partnerships by shares) (Avecilla, 1849, 98–9). In place of free incorporation, any new corporation would require authorization by Queen Isabel II herself. These restrictions had notable exceptions that suggested the existence of a complex network of lobbies and political interests (Tortella, 1968). The drafter of the 1829 code, Sáinz de Andino, defended these new restrictions in the Senate. He argued that in the 1820s free incorporation had had a specific purpose: to repatriate the capital of the

lost colonial empire (1827); giving freedom to the owners; and making the meagre economic conditions of the metropolis more appealing (Sáinz de Andino, 1847, 281). In the 1850s, the government kept the general ban on free incorporation, although, pressured by the needs of the treasury, it passed several laws that allowed the creation of corporations in the fields of banking, mining and railways (Bernal, 2004). These measures opened up a decade of growth and economic prosperity (1856–65) starting with corporations in the leading sectors of the economy, although led by foreign capital.

At the end of the 1860s a *coup d'état* overthrew the monarchy (*Revolución Gloriosa*, Glorious Revolution, 1868). The priority of the new regime was for Spain to resume its path towards social and economic modernization, that is, towards Europe. One of the new government's first measures was to pass a new constitution that respected individual freedoms (art. 17, Constitution of 1869). There were also several legislative changes inspired by major European advances.

Most important for this chapter, the Royal Decree of 28 October (1869) reestablished the articles of the Commercial Code of 1829 related to corporations (and limited partnerships by shares), suspended since 1848. The direct authorization of the government was once again replaced by the more lenient requirement of public registration and the periodical publication of the main results of the balance sheet (Matilla, 1996, 397–9).

In 1869 the Minister of Development, Echegaray, appointed a commission to revise the Commercial Code. The experts appointed to the commission had strong convictions about the economic implications of freedom and this spirit remained intact during the long project to develop a new code, which was not finished until 1885. The preamble of the 1885 Commercial Code demonstrated a deep respect for several dimensions of freedom in organizing and managing business firms: (1) freedom of owners to define the structure of the firm according to their needs; (2) absence of state intervention in the creation and life of firms and (3) principle of public disclosure of the registered documents of firms (Girón, 1986, 174). A significant part of the new articles of the company law came from the old Commercial Code (1829), although there were innovations as well. The flexibility of the law, present in the previous code, went a step further by breaking the principle of *numerus clausus* for the creation of multiowner enterprises, meaning companies were no longer limited to the standard forms prescribed by law (art. 122, Commercial Code, 1885) (Martínez-Rodríguez, 2016). The characteristics of the three standard forms (regular partnerships, limited partnerships and corporations) were updated to the forms we are familiar with today.

The corporation, in particular, was a modern corporation, meaning that it had a legal personality (Girón, 1986, 205). In the parliamentary debate, before the approval of the code, some members of the *Cortes* (Spain's Courts) expressed their concerns. Among them, Macià Bonaplata criticized some articles of the new Commercial Code for being less innovative than the law of 1869 (regarding freedom to issue bonds and voting rules). Others contended that the corporation should be a legal form only available to larger companies (Journal of Sessions of the Courts, Session 24 January 1883, No. 29, 603).

Despite that, the provisions of the new code were quite flexible; they did not require a certain number of shareholders or minimum capital, nor set out the characteristics of the shares; nor were there any accounting regulations beyond the formal requirement to publish the balance sheet once a year. This flexibility allowed the creation of a heterogeneity of firms called 'corporations' that were very different from the standard corporate form – used exclusively for large companies – of neighbouring countries.

3. FIRST THIRD OF THE TWENTIETH CENTURY: MANY PROJECTS AND FEW LAWS

The first significant action of the 20th century that had an impact on the corporation was the legalization of the private limited liability company (*Sociedad de Responsabilidad Limitada*, SRL, 1919). Despite the simplicity of corporation regulation in Spain, this new type of firm was a reaction to innovations taking place in the major European economies. The introduction of the SRL is one of the most interesting episodes of Spanish company law in the twentieth century, because it shows an unusual dynamism in the way a civil law country could introduce innovations through practice, rather than regulation.[3] The Business Registry Regulation (1919) established a protocol to register SRLs. Previously registration of any SRL was extremely rare. Due to gaps in the law

[3] In the last decade, there have been numerous economic studies suggesting that the legal family (of a country) is an institutional determinant that (clearly) impacts the economic development. This literature largely derives from La Porta et al, who contend that countries that have followed the civil law model, in particular those which have followed the French code, have endured negative effects on financial development derived from the measures of the code itself and how slow is the process of change. On the opposite side is the common law

(or the total absence of written law), before 1919 notaries advised their clients against the SRL, recommending other types of firms. While the aforementioned flexibility did not prevent the registration of any firm that was different from the standard as defined in the code (regular partnerships, limited partnerships and corporations), in practice, whether a firm that did not correspond to a known legal form was registered or not depended on the will and criteria of the Registrar. The regulation of 1919 put an end to this arbitrariness, leading to the proliferation of SRLs. However, while SRLs were registered after 1919, no law was established to regulate SRLs until 1953. The applicable legislation before then were the default rules of the Code for partnerships, rulings of the Supreme Court and the resolutions of the General Directorate of Civil Registry and Notaries regarding SRLs (Martínez-Rodríguez, 2016). It is striking that the Business Registry and the General Directorate of Civil Registry and Notaries (both under the authority of the Ministry of Justice) had enough legal authority to introduce a new legal form, invoking the principle of *numerus apertus* contained in the Commercial Code. They did so without reservation. After the introduction of the 1919 regulations, the SRL spread successfully.

Between 1920 and 1930, vital signs of economic modernization began to appear in Spain: water, sanitation and electricity reached many homes for the first time. There was substantial improvement in the transport network, roads and public works. The first public monopolies were formed under the dictatorship of Primo de Rivera (1923–30) – e.g., CAMPSA (*Compañía Arrendataria del Monopolio del Petróleo, SA*, a state-owned petroleum product monopoly). The electrical industry optimistically entered an initial phase of expansion, as did the chemical industry. Some of these developments failed, however, due to dependence on foreign supplies and the lack of local expertise. Nevertheless, the economy was changing; there were no substantial alterations to corporation law, but there were some major attempts at reform.

Before Europe was overrun by fascist movements, Spain found itself under the dictatorship of Primo de Rivera (Santos Juliá, 2003, 61), who imposed an authoritarian and nationalist regime (Ben-Ami, 1977, 68, 80) in a society exhausted from a two-party system. The main two political parties had had a tacit agreement to take turns in Government since 1885. After the economic upswing of the First World War, economic crisis struck Spanish society. The traditional political parties become weaker,

system with its innovations/legal changes made in court, answering the request of business persons who litigate for what they consider to be their rights.

unable to provide answers to new social demands (the rise of worker ideologies) and economic challenges. After seizing power, the dictator questioned the basis of the liberal system and gave the state a key role in economic and social life (Perfecto, 2006, 211). The growing number of corporations, and the legal framework that supported them (the Commercial Code), began to be questioned by a minority of intellectuals who were close supporters of the regime. The business class openly rejected these intellectuals' ideas, which clearly ran counter to their interests in greater flexibility for creating new businesses and in the total absence of effective or institutional control of the private sphere of the economy.

In 1925 the prestigious journal *Revista General de Legislación y Jurisprudencia* (General Journal of Legislation and Jurisprudence) launched a survey that predicted the wave of anti-liberal sentiment that would be experienced years later. It asked 25 intellectuals the question: 'Is Government intervention in corporations advisable or not?' Those surveyed included jurists involved in Government (past or present), academics (scholars and professors of law, of course), directors of credit institutions and even some senior executives of corporations (e.g., the deputy director of the *Sociedad General Azucarera* – Sugar General Society). Barely a third of the responses showed any agreement with Government involvement in the economy, including governing corporations. An overwhelming majority agreed on the need to improve processes in order to comply with the exact text of the law and the functioning of the institutions. Respondents agreed that there were mechanisms within the law for controlling the behaviour of corporations, but more were required to help enforce the law and other regulations, and ensure they were obeyed. Among the 25 survey respondents, a professor of law (Moret) said that rather than intervention in corporations, trade and industry needed a new legal form that suited the needs of the small- and medium-size enterprises (SMEs) that dominated the business network. Overall, the survey reflected the need to improve the regulatory framework of corporations, using a new legal instrument or ensuring full compliance with the current code.

The survey by the journal was triggered by the financial crisis of credit institutions at the beginning of the 1920s, which provided an excuse for the Government of the dictator Primo de Rivera to move towards greater interference in the economy (a feature of the corporatist regime). The first measures adopted were protectionist (and nationalist) regulation of banking. (The Royal Order of 21 September 1922 established that any private bank declared bankrupt had to submit a probatory balance sheet

to the *Comisión Regia de Ordenanzas de la Banca Privada* – Royal Commission of Private Banking Ordinances.) Corporations were the next target.

Around the same time, the Government commissioned a group of experts to draw up a new commercial code. The first part of the proposed new code, issued in 1926, amended contract law (Book II. Special commerce contracts). The move was justified with the argument that the modernization of contracts and legal forms was imperative to meet economic needs. One section that received high praise from the public was the new proposal for multiowner enterprises, compiled by Goicoechea. He proposed a text with five legal forms: regular partnerships, limited partnerships, SRLs, corporations and cooperatives. He also put an end to the flexibility of the previous code (*numerus apertus*) by requiring every firm to adapt to one of the legal forms defined in the new code (art. 6).

Although these proposals were never adopted, they had a major impact on scholars, experts and institutions interested in legislative reform (e.g., chambers of commerce, associations, sectorial lobbies). The media also dedicated space to the code reform. The *Revista ilustrada de banca, ferrocarriles, industria y seguros* (Illustrated review of banking, railways, industry and insurance), a popular journal focused on the business sector, devoted a special section in more than 10 issues to explain to their readers the main points of the code reform. Another example was a detailed study published by one of the most prestigious scholarly law journals in the country, the *Revista de Derecho Privad*o (Journal of Private Law).

Regarding corporations, the projected Commercial Code proposed regulating aspects that had previously been at the discretion of the shareholders. The 1885 Commercial Code devoted 18 articles to issues related to corporations; in the proposed 1926 code there were 35. Some articles remained the same; the short definition of corporation, for example. The draft code paid special attention to reserving the use of the corporation for larger entities, as these firms would be the ones able to fulfil new requirements with regard to supervisory bodies. Also new were requirements concerning the valuation of assets and the characterization of shares, as well as maintaining a set of good practices related to the publication of balance sheets and other relevant information. Of more general interest was the fact that the code required a minimum of five members to form a corporation (the 1885 code had made no reference to the size of the corporations). Lastly, in the 1926 code, the Government reserved the right to perform inspections of the corporation, a feature that matched the (radical) authoritarian nationalist regime of Primo de Rivera, which opposed the freedoms embodied in the 1885 code.

The project for the new Commercial Code also included a section for the (still) unregulated SRL. These SRLs were defined by omission: when the legal form was not any other standard type of enterprise (regular partnership, limited partnership or corporation), when all the owners limited their liability to their capital contribution and when the firm had a registered company name (*razón social*), then it was an SRL (art. 6.3). Goicoechea pointed out in his report that the SRL was a type of private limited company (*Sociedad anónima privada*) or a family corporation with fixed capital (*Sociedad anónima familiar de capital fijo*) (Eizaga, 1946). He also pointed out that the SRL was a type of special family partnership that combined the characteristics of partnerships and corporations. With these thoughts on the hybrid nature of the SRL, he was also reflecting the views of the General Directorate of Civil Registry and Notaries, whose resolutions tended to favour this ambiguous position. Among the main features of SRLs we can highlight the minimum required contribution of each owner (15,000 pesetas) and the maximum number of 50 owners. An SRL could also have a commercial name in addition to its registered company name. Plus, the manager could be someone from outside the firm, not only one of the owners; and the shares in the capital stock could even be bearer bonds (Eizaga, 1946, 90). The jurist Pérez-Serrano was especially critical of the articles of the SRL. He criticized the strong French influence (1925 law on PLLC) when several projects had already been developed previously in Spain and – according to him – there was no need to borrow from French legislation (Pérez-Serrano, 1927, 17).

3.1 Winds of Change, New Ideas

In the early 1930s, several studies appeared that reflected the spread of the corporatist movement. The anti-liberal character of fascist and totalitarian ideologies led to the rejection of one of the most emblematic elements of the liberal economic system: the corporation (Aragoneses, 2008, 287). Garrigues represented a new generation of intellectuals who had been educated abroad and away from previous dominant doctrines. Garrigues would later be the main drafter of the Corporation Law (1951) and SRL Law (1953).

The work of Garrigues had a clear impact on Falangist groups, although it lacked effective influence during the regime established in 1931: a Republic.[4] Garrigues in his work *Nuevos hechos, nuevo derecho*

[4] The most significant manifestation of fascism in Spain was Falangism. The *Falange Española* was a political party founded in 1933 (Payne, 1999).

de Sociedades Anónimas (New facts, new corporation law, 1933) accused the democratic principle of corporations of being the main culprit causing individualism in mercantile life. The book introduced theories of corporatism to Spain: for Garrigues, the corporation was a legal form suited to larger firms. Highlighting Germany's experience, he emphasized that recent developments had shown that in corporations there was a significant gap between the owner of the firm and its managers (Garrigues, 1933, 39). He warned that the private interest of the principal shareholders, who were focused on immediate profit, could hinder company development. As a way of avoiding this, Garrigues proposed Government intervention to protect corporations from the individualism of their shareholders (Garrigues, 1933, 77).

Another element Garrigues emphasized was the danger faced by minority shareholders. The democratic principle of 'one share one vote' marginalized them, and reinforced the need, he argued, for Government intervention to prevent majority shareholders from abusing their position.

4. FRANQUISM AND THE FIRST CORPORATION LAW IN SPAIN (1951)

The republican regime coincided with a climate of social instability that would result in the military uprising of 1936. During the civil war, the Government took a series of emergency measures that relaxed the obligations of firms regarding taxation and the publication of balance sheets (Decree 220 of February 2, 1937). After the civil war, Franco's first actions were aimed at protecting and controlling domestic industry (*Ley de Protección y Fomento de la Industria Nacional*, also named *Ordenación de la Industria Nacional*, 24 November 1939 [Law on the Protection and Promotion of National Industry, also called Management of National Industry]). The regime had a particular interest in controlling industry, notably corporations. In this regard, several provisions were adopted requiring authorization for any changes in capital stock. The law of 19 September 1942 required corporations and SRLs to have a compulsory capital reserve and to seek authorization for certain increases in capital. The Order of 14 June 1946 defined which kinds of corporations were obliged to request permission for any variation to their capital. Both acts were passed within the framework of the Commercial Code of 1885, while at the same time implicitly criticizing its liberal nature.

The *Instituto Nacional de Industria* (National Institute of Industry) was established in 1941, following the example of another Italian public

holding company funded by Mussolini, the *Istituto per la Ricostruzione Industriale* (Institute for Industrial Reconstruction) founded by the fascist regime to restructure and finance Italian business. In Spain, the *Instituto Nacional de Industria* also carried out nationalizations in some of the main sectors of activity, becoming the operator of some firms. In 1941 the railway system passed into Government hands under the name RENFE (*Red Nacional de Ferrocarriles*, Españoles, National Network of Spanish Railways). The main feature of this autarchic policy was the intervention in, and protection of, large firms and the financial system. The instruments designed to favour national industries were subsidies and other privileges.

The defeat of fascism after World War II forced Franco to redefine the basis of his political relationships (and alliances) with Western Europe. In this changing environment, the regime recognized the need to update its regulations on corporations. An example of its adapting to the new political environment was the change of direction of the *Instituto de Estudios Fiscales* (Institute of Fiscal Studies).[5] In 1947, and in response to a request from the Ministry of Justice, the *Instituto de Estudios Fiscales* published a draft bill on corporations (Garrigues et al, 1947). The drafters of the project (led by the abovementioned Garrigues) emphasized from the beginning that the reform was ‘a technical reform’, within the legal framework established by the 1885 Commercial Code. The introduction to the project refers to the ideology of the fascist regime and expressly acknowledges the *Fuero del Trabajo* (Labour Charter),[6] but this ideological recognition was merely formal. There was no trace of fascist and corporatist principles in the bill’s articles. The draft corporation bill limited the power of shareholder meetings, and emphasized that the legal form of the corporation was exclusively for use with large companies.

The final draft was widely discussed. In fact, both the debate itself and the size of it were unprecedented in the legal history of corporations in Spain. The circumstances were also special: Spain was under a dictatorship where the freedom of expression was suppressed. Once the draft had been published, it became the subject of a report (*Redacción del*

[5] A study and propaganda centre, supported by the Government, that then paid particular attention to the international image and relationships of the regime.

[6] One of the eight fundamental laws of the Franco regime that copied the main ideas of the Italian *Carta di Lavoro* that regulated the labour market.

Anteproyecto: Decreto del Ministerio de Justicia de 20 de Mayo de 1949, Preparation of the Draft bill. Decree of the Ministry of Justice of 20 May 1949).

The *ABC*, a major national daily newspaper that was by no means suspected of opposing the regime, criticized many aspects of the new law: its numerous financial requirements, overregulation and the mistrust it showed towards managers were the predominant complaints (ABC, July 12, 1949). However, the main media offensive came from Catalonia. The major newspaper *El Correo Catalán* (The Catalan Mail) surveyed 18 specialists with only two questions: '(1) What are the pros and cons of the draft bill on corporations? (2) What do you consider the most important aspect of it?' (VV.AA, 1949). The proposed requirement that corporations have minimum capital of five million pesetas provoked the most reaction. This restriction, warned the newspaper, would destroy thousands of Catalonian family businesses already established as corporations.

The *Cámara Oficial de Comercio y Navegación de Barcelona* (Barcelona Chamber of Commerce and Navigation), which spoke for the majority of the economic and financial sectors in Catalonia, sent a detailed report to the Ministry of Justice in which it stated its opposition to the new corporation law (*Cámara Oficial de Comercio y Navegación de Barcelona*, 1949, 1–7/ Barcelona Chamber of Commerce and Navigation). The Chamber saw how their support of the regime now turned against them when the Government claimed direct control over their corporations (Cabrera and Rey, 2008, 324–8). They clearly opposed any Government intervention in the activity of the corporation. Compared to the minimal regulation of corporations contained in the existing code, any small change would mean restricting the freedom of owners. Moreover, the Chamber warned of the damage SMEs would suffer as a result of the draft bill. The accusation of interventionism showed how comfortable business owners had become with a flexible legal framework, even under a fascist dictatorship. Rojo, a legal scholar, agreed that although the corporate form had been created initially for larger firms, in Latin (European) countries it had acquired a versatile character. Spain was the perfect example of this flexibility (Rojo, 1988, 7; Guinnane and Martínez-Rodríguez, 2014). Another scholar, Polo, stated later that the severity used by contemporaries to criticize the corporation law (LSA51 onwards), was an example of the backward nature of Spanish corporation law, equivalent to the French corporation law of 1867 (Polo, 1991).

Several specialist magazines (such as *Anuario de Derecho Civil*, *Boletín de Estudios Económicos*, *Revista de Estudios Políticos*/ Yearbook of Civil Law, Economic Studies Bulletin, Journal of Political Studies)

also expressed their opinion on the draft corporation bill (Castro y Bravo, 1950, 57; Girón, 1949). Undoubtedly, the strongest support for the new law (LSA51) came from *Revista de Derecho Mercantil* (Journal of Commercial Law), edited by Garrigues. The journal launched a special issue with contributions from national and international experts, most lauding the new law. Garrigues himself wrote the strongest defence of the corporation project (*Reforma, contrarreforma y ultrarreforma de la Sociedad Anónima*, 1950 [Reform, counter-reform and ultra-reform in the corporation form]).

The revision of the draft brought significant changes. Even though the matter of minimum capital attracted the harshest criticism, it was a very common criterion in European legislation (art. 4 of the Draft Bill). The final approved text established that firms with more than five million in capital stock had to register as a corporation. However, it also left open the option for firms with less than five million to register as corporations. The preamble also indicated that the commission was preparing a new SRL law, which was to complement the new corporation regulations and provide for smaller firms that wanted to enjoy the benefits of the legal form of the corporation, without bearing the burden of its legal requirements. The drafters of the corporation law acknowledged that among the reasons for eliminating the minimum capital requirement was the shared desire to foster family corporations, which were especially prolific in Catalonia (Garrigues, 1953, 125–6). Another important innovation was that the law required a minimum actual contribution of 25 per cent of the total capital at incorporation.

The drafting process of the SRL law (LSRL53) was much faster, and had a more modest social and intellectual impact. Only the specialist journal *Revista Jurídica Catalana* (Catalonian Law Journal) launched a special issue, aware of the impact that the SRL could have in Catalonia, due to the industrial characteristics of the region.

The SRL law conceived of the SRL as a catch-all for all the old corporations that were unable to fulfill the new legal requirements. Numerous provisions from the LSRL53 reproduced the wording of LSA51 (Lasso, 1998, 389). The legal characteristics of the SRL were the following: (1) capital paid up at the time the company was registered into the Business Register, capital divided into equal, accumulative and indivisible participations; (2) the participations could not be incorporated into negotiable securities, nor be named shares; and (3) the owners were not personally liable for company debts, and they were only liable to the sum of their capital participation (art. 1, LSRL53) (Boix, 1953, 514). The criticism was that the limit of the maximum number of owners – 50 (art. 1, LSRS53) – was influenced by foreign laws, rather than national

experience, which showed that no SRL had more than 15 owners. The law established a maximum capital of five million, but again there was no minimum requirement, in contrast to PLLC legislation in other European countries, which did set minimum capital requirements. (The request for a minimum capital sum was actually refused in the parliamentary debate.) The foreign press praised the goodwill of the Spanish legislature for bringing corporations up-to-date and adopting the PLLC formula for smaller firms (Gullón, 1954, 264).

In the wider European context, the PLLC provided an answer for firms that wanted limited liability for all owners without paying the cost of the more stringent legal requirements for corporations. The situation in Spain was not the same, since the restrictions on incorporation were practically non-existent (Guinnane and Martínez-Rodríguez, 2014). However, the SRL provided an answer for entrepreneurs who wanted more options for creating multiowner firms, and for Notary Publics who required legal instruments like those of the leading European economies (Martínez-Rodríguez, 2016). The first documented phase of SRLs in Spain – from the first regulation requiring their registration in the Business Register in 1919, to the first act in 1953 reflects a striking fact: a change in nature. This expression may seem misguided, however it matches the facts. While the SRL avoided significant regulation until 1953, after 1919 entrepeneurs created a large number of them. The Guinanne and Martínez-Rodríguez database for SRLs (1920–36) shows that the new firms were larger than regular partnerships, with the capital divided into participations and with a company name (or a registered business name and a commercial name) (Guinnane and Martínez-Rodríguez, 2017).

In the absence of positive laws, the SRL followed the default rules of the Commercial Code for partnerships. Nevertheless, the first resolutions of the General Directorate of Civil Registry and Notaries (in the 1930s and the first half of the 1940s) underlined the idea that the new legal form was hybrid in nature, with characteristics of both partnerships and corporations. The controversy was set, and it reached the Supreme Court. In a Supreme Court judgment (5 July 1941), the judge who signed the decision, Castán, clearly linked the partnership to the SRL. In a commentary on that judgment another jurist, Polo, expressed his concern about the Supreme Court statement. To link partnerships to SRLs, he noted, clearly raised the question as to why limited liability was an essential characteristic of the partnership (Polo, 1942). Nevertheless, some scholars like Vicente-Gella praised the Supreme Court decision. From his point of view, the Supreme Court was ratifying a proximity between the SRL and the partnership that in practice was already known (Vicente-Gella, 1941).

The different opinions of the most prestigious jurists of the time show there was great disagreement about the SRL. As the Supreme Court justice who signed the judgment, Castán, spoke of an entity similar to partnership and the SRL, he focused basically on the size of the firm (capital and number of owners) (Vicente-Gella, 1941). The experts who likened the SRL to the corporation had two legal references. The first was tax law. Tax regulation in Spain had taxed all firms with limited liability in the same way. The tax reform of 1922, and later that of 1940, catalouged the SRL as a legal form that was closer in nature to the corporation, and both were taxed in a similar category. The second legal reference was the knowledge that a team under Garrigues's leadership (from the *Instituto de Estudios Fiscales*) was in the process of writing a new law for corporations, which reserved this legal form exclusively for larger firms. Applying elementary logic, all the firms excluded (or expelled) from the form of the corporation would have to find themselves another niche. It would, therefore, be easier to define an SRL as a small, or more modest, corporation.

5. HARMONIZING WITH THE EUROPEAN UNION DIRECTIVES (1989–2010)

The official integration of Spain into the EEC in 1986 required – among other things – adapting its business legislation to the European directives on firms (Royal Legislative Decree 1564/1989 of commitment 22 December 1989).[7] The corporation law of 1989 was the direct consequence of this agreement. Some experts claimed that the law was written too hastily and, as a result, was incomplete, nothing that had not been heard before. To be fair, the commission itself declared that it was only a partial reform, and other changes would follow it (Fernández de la Gándara, 1980, 582). Other authors, however, praised the efforts of the legislature to adapt all the existing directives (Polo, 1991, 65).

The new draft bill generated a profound debate in Spain about the scale and impact of supra-European legislation in Member States of the EEC. In Spain, a process of devolution of responsibilities from the state to the regional communities was also in full swing. These debates were

[7] Polo (1991, 52) noted that since 1965 there had been several corporation reform projects in Spain that had failed due to their ambitious objectives.

overlapping. Even the *Consejo de Estado* (the Council of State)[8] reflected upon the consequences of the European Regulation and the best way to implement the recommendation of the European legal body (Council of State, 1989, 44–50).

The new corporation law drew in part from the draft bill of the corporation law of 1979, which never came to fruition. It was a work signed by the *Comisión Central de Codificación* (Central Codification Committee). The head of that team, Menéndez, was also focused on adapting European business regulations to the Spanish corporate legal framework (*Resultado del proyecto de ley nº 121/000081 de 'Reforma parcial y adaptación de la legislación mercantil a las Directivas de la Comunidad Económica Europea'*, Result of the Project No. 121/000081 'Partial Reform and adaptation of commercial legislation to the directives of the EEC'). In both cases (1979 and 1989) the starting point was a thorough revision of LSA51, motivated by the European requirement, although the law itself needed some modernization to be able to respond adequately to the new economy.

The first EEC condition to be met was the minimum capital needed to create a corporation (European Directive 13/12/1976, art. 4). All the countries in the area had established that the corporation was a legal instrument for firms with at least a certain amount of capital. Adopting this measure, Spain definitively abandoned the tradition of small-scale corporations, and ratified its will to keep the legal form only for large entities. Jurists interpreted this change as a 'fundamental innovation' and a sign of modernization in Spanish corporation law (Uría, Menéndez and Olivencia, 2007). It is worth remembering that Garrigues himself had made a similar, but unsuccessful, proposal.

The changes to LSA1951 affected a wide range of sections: the establishment of a company; characteristics of shares; increase or reduction of capital; transformation, dissolution and merger; accounting balance rules; and amendment of the articles of association (Girón, 1999; Polo, 1991). The legislature postponed any modification of balance sheet requirements until significant changes to the general accounting law had been completed (Girón, 1999, 635). Chapters relating to registration and the publication of information required fundamental changes. The hallmark of Spanish company law (the Commercial Code itself) was the principle of publication, based on registration in the Business Register.

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[8] *Consejo de Estado* (State Council) is the supreme consultative body of the Government (art. 107 Constitución, art. 1.1. Ley Orgánica 3/1980, de 22 de Abril.

The registration of a corporation signified the birth of the corporation as a legal form ruled by law (not only a private agreement) (art. 6 LSA51). Registration and public disclosure meant that a corporation could be formed by anyone who met a set of legal requirements and who accepted the obligation to disclose private information of the corporation to third parties. The commercial code formally required corporations to publish their balance sheets in *La Gaceta* (Official Gazette),[9] although this practice was never enforced, and corporations mostly ignored it from the beginning. Once again the absence of disciplinary measures led to non-compliance (Girón, 1999, 639). The first European directive (68/151/EEC), in addition to calling for major acts of corporations to be registered, required the corporations to publish the information in an Official Bulletin (Gazette). The Spanish legal framework finally added this measure to its legal corpus.

LSA89 was a major milestone in the reform of company law in Spain, but it was not the only one. Another fundamental innovation was the new *Ley de Mercado de Valores* (Securities Market Act (1988)) and the *Reglamento del Registro Mercantil* (Business Register Regulation, RD 1597/1989, 29 December). The SRL Act passed in 1995 caused concern among business persons because of the economic stagnation and recession in the labour market (Fernández de la Gándara, 1994). Unlike the former SRL Act, conceived as a mere complement to LSA1951, the *Comisión General de Codificación* (Law Commission) prepared a draft of 131 articles, plus additional provisions, for the new SRL Act (the previous law had 32 articles). The new SRL was planned as a flexible and practical legal instrument for any firm seeking operational simplicity, without limiting stock capital or the number of owners.[10] To amend earlier decisions, the preamble of the SRL law defined the SRL as an individual and autonomous firm, which meant that it was no longer conceived as a version of the corporation. Unfortunately, the spirit of the law did not always match the letter of it. Several times the Act's articles repeated the idea that the SRL was a smaller and simpler corporation. Some examples that demonstrated its similarity to a corporation were its characterization of the General Meeting and of the rights of the individual owners. According to the experts, the characteristics of the SRL continued to overlap the corporation (Fernández de la Gándara, 1994, 127). Despite the efforts of the legislators to improve the legal framework

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[9] *La Gaceta* (Official Gazette) was an official Government and Parliament gazette where all regulations, acts and designations were published.

[10] The project itself had a maximum of 10 million pesetas, which was widely criticized (Fernández de Gándara, 1994, 126).

– at least for the number of articles – scholars and lawyers continued to consider the SRL a legal form 'virtually ignored by scientific studies', lacking prestige and lean in legislative resources (Menéndez, 2006, 119). Nevertheless, in areas such as the dissolution and liquidation of companies, the regulation of the SRL was more attractive than the corporations' one, manifestly obsolete after just a few years. Later, at the beginning of the twenty-first century, another significant innovation was the regulation of companies listed on the stock market. Paradoxically, until 2003 this regulation was virtually non-existent (Law 26/2003 of 17 July Stock Market law, title 10, addition to the corporation act).

In the late twentieth century, the umbrella term 'corporation' still sheltered a number of different beasts. On the one hand, there were the big businesses: the standard corporations with capital divided into shares, a large number of owners, etc., some of which were listed on the stock market. On the other hand, there were smaller firms, also called corporations, with their capital formally divided into shares. Those smaller firms' owners, however, did not generally speculate with their shares and normally took part in the firm's decision making.

We should avoid the temptation to call this a Spanish exception. It is true that due to the aforementioned flexibility of Spanish company law, and particularly the corporate form, the uses were profoundly heterogeneous. Nevertheless, Rojo noted that among the European countries that shared a civil legal system two traditions were clearly distinguishable (Rojo, 1988). The German corporation, '*Aktiengesellschaft*' was highly prescriptive: it was designed for ventures that required a high level of investment, and therefore appealed to the public to raise funds. The French '*Société Anonyme*' represented a tradition shaped in a wider sense: medium and even small enterprises could use the corporation form, because the legal requirements of size were weak. Italy, Belgium and Spain also shared the Latin tradition. Countries under the influence of common law could also show flexibility in the use of the corporation, although I will not analyse the issue here (Guinnane et al, 2014). In comparison to all other cases and contexts, Spain was extremely flexible in this aspect, which is the fruit of its particular legal history, where a late liberal code left the rules governing corporations largely to the contracting parties themselves.

Spanish corporation law as a whole was a long way from being a single, fundamental text: there were gaps, overlaps and reiterations. Therefore, the legislature insisted all the information be consolidated into a single text. The preamble to the *Ley de Sociedades de Capital* [Corporations Law] (Law 1/2010, 2 July approving the revised text of the Corporations Law) explained the end of the previous plurality of legal

texts, and provided a single, consolidated and updated text for all corporations. Paradoxically, this so-called corporations law hid two separate sections: one for the corporation itself, and the second for the SRL (Andenas and Wooldridge, 2009, 83–9). Each of them kept a single identity, but they were different from each other. The law's text warned that it would be only the first step in the regularization and harmonization process to bring it into line with European corporation law. However, if the legislator were also a historian she would have understood that the evolution of the corporation has rather been a history of its reforms and absences.

6. FINAL COMMENTS

The nineteenth century codes symbolized the triumph of order and rationality: all regulations related to a particular field were compressed into a single volume. Following the example – or imposition – of the French code, several countries made the code the cornerstone of their legal system, replacing previous disparate legislation (laws, rules and compilations).

Progress in economic modernization and the need to introduce new regulations for business and firms pushed some countries to choose to decodify their civil law system. The decodification process – which meant that new additions to company law ran parallel across the code – led to a combination of a civil law country satisfying this need by retaining the visible symbol of the code, but updating its legislation quickly with regular laws. An early example was French corporation law in the mid-nineteenth century France, in a four-year interval fully liberalized the creation of corporations with two steps: 1863 and 1867. To begin with, free incorporation was only available for corporations with less than a certain amount of capital. After 1867 the full process of free incorporation was available for any corporation, regardless of its stock capital.

Spain then passed free incorporation in a separate law in 1869, while the Commercial Code of 1829 remained suspended. (The Commercial Code of 1829 agreed with free incorporation, although it was in operation a short time.) The legislature pointed out that the law would remain in force until a commission worked out a new Commercial Code. After a lengthy review process, a new commercial code, which kept free incorporation, was approved in 1885. This code followed the purest liberal tradition and granted venturers full freedom to agree on any terms in their organizational agreement. Moving to the area of corporations, this trend translated into fewer requirements, from which business persons in Spain

were benefited by being exempt from complying with long lists of conditions – as was the case in Germany and France. However, the favourable legislation was not able to promote the development of corporations until several decades later, due to limited economic modernization and political instability.

The first corporation law appeared in the aftermath of World War II, in a political regime with clearly fascist leanings. Spain felt the pressure of the international political context and the need to redefine its alliances with the winning side. The Franco regime opted for a 'technical' corporation law, which meant adapting the form of the corporation to the characteristics and attributes of a modern one. The loss of corporations' freedom to determine their organizational terms was undoubtedly a factor that accelerated the approval of the first SRL law, which had been unregulated up to that point (following the guidelines of the Commercial Code, the rulings of the Supreme Court and the regulations of the General Directorate of Civil Registry and Notaries). The SRL law was intended to cover all firms incapable of meeting the requirements of the new corporation.

Developments in Europe also marked the second major legislative change in Spanish corporations. Entry into the EEC required a number of legislative reforms to bring the country in line with European directives. One of those European mandates, strongly influenced by German company law, stipulated the reservation of the corporation to large enterprises only, a norm which was finally adopted in Spain. Spain's flexible rules on corporations had led to great disparity in the types of firms being called corporations: from large companies, with a large amount of capital and many shareholders, to medium – and even small – entities formed by only a few owners with little capital. The latter complied with the stereotype of a partnership with limited liability for all members.

In the course of less than 50 years Spain embarked on several major debates: tackling a decodification process for the company law, and adapting it to a modern economic environment, as well as trying to fit into the European framework. None of these debates has been concluded. We have closed the history of the Spanish corporations – temporarily – in the hope that any upcoming changes will help policy makers drive economic development, having read about past failures.

In half a century, Spain went from having an exceptionally sparse corporation law (compared with surrounding countries) to possessing a legal corpus comparable with other leading countries. During this period, Spain changed its economic physiognomy and has emerged as a fully developed country. It also reorganized its entire company law, first with the emergence of the SRL, and later with various other types of

corporations, such as the sole-proprietor corporation. The debates, changes to, and transformations of, corporation law discussed in this chapter, from a historical and institutional context, aim to provide a broad overview of more general issues such as the decodification process: harmonization (first) and insertion (later) into the European supranational context.

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12. EU company law harmonization between convergence and varieties of capitalism

Martin Gelter

1. INTRODUCTION

The European Union (EU) came into being as a result of the Maastricht Treaty, which came into force in 1993.[1] However, its history can be traced back to the formation of the European Coal and Steel Community (1951), the European Atomic Energy Community (1957), and most importantly the European Economic Community (EEC), which was created by the Treaty of Rome, which was signed by the original six Member States on 25 March 1957, and came into force on 1 January 1958.[2] The transition period, after which all of the rules relating to the internal market came into full force, ended on 31 December 1969. Corporate law (or company law, as it is usually called in the European context) has largely remained a prerogative of the Member States, which retained their own company laws. Starting in the early years, company law became one of the areas that the European Community (EC) sought to harmonize between the Member States. Since then, the EEC/EC/EU has passed a large number of directives, i.e. supranational legislation directed at Member States and requiring implementation in national laws, as well as a number of regulations, which are directly applicable. The latter relate mainly to supranational legal forms. While practitioners tend to pay relatively little attention to EU company law, given that it typically impacts corporations only indirectly through its national implementations, it is a prominent subject in academic literature.

This state of affairs looks somewhat unusual from overseas. Generally, with a few exceptions, most countries outside the EU have their own, formally independent national company laws. In the United States, by contrast, each constituent State has its own corporate law, in spite of the

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[1] Treaty on European Union, signed at Maastricht on 7 February 1992, 35 O.J. (C 191) 1.

[2] Treaty Establishing the European Economic Community, 25 March 1957, art. 54(3)(g).

country's integrated national economy, without any national harmonization effort as such (leaving aside the Model Business Corporation Act). Yet, it is often thought that regulatory competition between the States has contributed to the relative uniformity of corporate law in the US. There is no uniform assessment of company law harmonization in the EU; views vary between characterizing company law as a 'success story of European efforts to regulate' (Kalss and Klampfl 2015, ¶ 1), and the claim that EU Company law is 'trivial' (Enriques 2006).

This chapter sketches the history of EU company law, from its beginnings in the 1960s until today. While I do not take a strong position on the triviality thesis, I argue that the development of EU company law can be understood as reflecting two distinct periods of convergence in corporate law, even if that convergence has often been limited to specific issues and sometimes remained restricted to the formal level. Company law harmonization efforts mirror prevailing fashions about what is considered good corporate law. Each of these periods is roughly linked to the success of a particular model of capitalism that seemed to be on the ascendancy at the respective time. The first one began with the formation of the EEC, when the goal was minimum harmonization and the prevention of a European Delaware. Harmonization decelerated and was almost brought to a halt by the accession of the UK to the EU. This first period was characterized by a dominance of the German model, and a vision of corporate law that one could characterize as belonging to a 'coordinated' variety of capitalism, when shareholder value maximization was not yet the prime directive of corporate law.

The second period began in the late 1990s and partly coincides with the 'convergence in corporate governance' debate. This period was dominated by liberal capitalism oriented toward shareholders and increasingly the stock markets. Germany had lost its position as the model jurisdiction for what was considered good corporate law, a role that was increasingly taken over by the UK. Harmonization projects tended to shift to issues more strongly associated with capital markets. Even where capital markets were not involved, harmonization focused less on minimum substantive standards, and more strongly on transparency and interaction with informed shareholders. Compromise had to be reached on traditional 'regulatory' projects, and the European Court of Justice's (ECJ) case law forced the hands of the Member States.

This chapter traces these two periods and attempts to sketch their historical development. Section 2 surveys the objectives of harmonization. Section 3 situates European corporate law harmonization in the convergence and varieties of capitalism debates, and seeks to categorize

specific examples of harmonization into the two periods. Section 4 summarizes and concludes.

2. OBJECTIVES OF COMPANY LAW HARMONIZATION: FROM ROME TO *CENTROS*

2.1 'Equivalent Safeguards'

EU company law began to emerge during the 1960s. The Treaty of Rome gave authority to the Council and the Commission to coordinate 'to the necessary extent the safeguards which, for the protection of the interests of members and others, are required by Member States of companies or firms […] to making such safeguards equivalent throughout the Community'.[3] The *raison d'être* for this provision was the fact that the Treaty extended the freedom of establishment to '[c]ompanies or firms formed in accordance with the law of a Member State and having their registered office, central administration or principal place of business within the Community'.[4] The larger goal was that shareholders, creditors, and other third parties interacting with firms across intra-European borders should be able to rely on a single set of minimum standards. The First Directive, which was passed in 1968,[5] provides an example. Applying both to public limited liability companies[6] and private limited liability companies,[7] it required certain disclosures (such as the company's statutes, the names of individuals authorized to represent it, as well as accounting information).[8] To protect third parties' reliance, it stipulated that contracts could not be repudiated on grounds of being *ultra vires*, and it limited circumstances under which the nullity of a corporation, which may only

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[3] EEC Treaty, art. 54(3)(g). Today this provision can be found in the current Consolidated Version of the Treaty on the Functioning of the European Union art. 50(2)(g), 2008 O.J. (C 115) 47 [hereinafter TFEU].

[4] EEC Treaty, art. 58 [now TFEU art. 54].

[5] First Council Directive of 9 March 1968 (68/151/EEC), 1968 O.J. (L 65) 8. The Directive has since been recodified as Directive 2009/101/EC, 2009 O.J. (L 258) 11.

[6] This includes the *Aktiengesellschaft* (AG), *société anonyme* (SA), and *società per azioni* (spa).

[7] This includes the *Gesellschaft mit beschränkter Haftung* (GmbH), société à responsabilité limitée (SARL), and società à responsabilità limitata (srl).

[8] Directive 2009/101/EC, art. 2.

have prospective effects, could be declared by a court (see e.g. Houin 1965, p. 14: Drury 1991, pp. 250–53).[9]

From the US perspective, this rationale might seem unusual. After all, the closest equivalent to company law harmonization in the US is the Model Business Corporation Act, on which the corporate law of a number of states is based. However, unlike EU directives, it is in no way mandatory. Even if one accepts the rationale for harmonization, the rationale might not apply with full force in the US primarily because greater homogeneity in the legal culture and shared language makes harm to third parties less likely in the first place.

2.2 Preventing Regulatory Arbitrage

A second rationale for harmonization was the fear of what we would today call corporate law arbitrage and a possible race to the bottom. At the time of the Treaty, of the six original Member States, all but the Netherlands applied the real seat rule to determine the law applicable to a corporation (e.g. Houin 1965, p. 22; Stein, 1971, pp. 29–31). According to this conflict of laws principle, a corporation is governed by the law where its head office (the centre of its actual commercial and financial operations) is located, unlike the incorporation theory (or the American 'internal affairs rule') where all that matters is the place of incorporation. The real seat theory serves mainly the protectionist purpose of shielding a particular corporate law system from the incursion of foreign firms governed by different laws. Generally, under this rule the State of incorporation and the location of the real seat must match. Otherwise, a jurisdiction applying it might deny a firm's legal capacity or treat it as a partnership (see e.g. Enriques and Gelter 2007, pp. 585–6; Menjucq 2016, p. 65).

Obviously, this rule was in tension with the freedom of establishment for companies. The contemporary understanding of the Treaty seemed to lean toward the view that, with respect to companies maintaining both a registered office and a real seat within the Community (Stein 1971, pp. 28–9), the Member States would effectively have to switch to the incorporation theory (e.g. Houin 1965, p. 24: Drobnig 1966, pp. 1012: Großfeld 1967, p. 18; Doralt 1969, p. 196; Conard 1973, pp. 56, 58; but see Leleux 1967, p. 149). During the negotiations, the French delegation was particularly concerned that the Netherlands, whose law was the most

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[9] Directive 68/151/EEC, art. 9 (regarding ultra vires), arts 10–12 (regarding nullity). In the recodified version of 2009/101/EC, art. 10 governs ultra vires, and arts 11–13 govern nullity.

permissive at the time, might become the Delaware of Europe (Timmermans 1984, p. 13; Timmermans 1991, p. 132). While the Treaty did not formally make company law harmonization a prerequisite to the freedom of establishment for companies, it was during the negotiations considered a *quid pro quo* (Timmermans 1984, pp. 12–14; Timmermans 1991, p. 132; see also Conard 1991, p. 2190).

In practice, the Member States attempted to use the fact that harmonization proceeded slowly as a justification to retain restrictions. While early on many assumed that harmonization would cover 'all provisions concerning structure and organs of companies, formation and maintenance of its capital, the composition of the profit and loss account, the issue of securities, mergers, conversions, liquidations, guarantees required in cases of company concentrations, etc'. (Wouters 2000, p. 268), some expected company law to be comprehensively harmonized by the end of the transition period of the EC Treaty in 1969 (Houin 1965, pp. 13–14). Following a two-year standoff between the Commission and the German government about the government's authorization for foreign firms to do business (Stein 1971, pp. 37–41; Johnston 2009, p. 117) and only one directive having been passed in 1968, the EEC fell far short of this goal. Several early writers argued that Member States could maintain restrictions until a comprehensive harmonization had been accomplished (Everling 1964, ¶ 312; Großfeld 1967, pp. 20–21; see also Stein 1971, pp. 162–3). The Member States signed a 'Convention on the Mutual Recognition of Companies and Bodies Corporate' in 1968,[10] but it did not come into force because the Netherlands did not ratify it (Timmermans 1991, p. 149; Conard 1991, p. 2161; Ebke 2000, p. 636 n. 83). Those defending restrictions thus felt that Member States were justified in retaining the protectionist conflict of law rules (see Behrens 1988, p. 512; Ebke 2000, p. 649).

This only changed with three cases handed down by the ECJ between 1999 and 2003. In *Centros*,[11] Danish nationals had incorporated the firm in England and Wales with the full intention of using it only for business purposes in Denmark. The Danish authorities refused to register a branch office, given that the English registration was obviously a sham. In *Überseering*,[12] the shares of a Dutch firm had been bought by German nationals, and the firm gradually shifted its business to Germany. German

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[10] Convention on the Mutual Recognition of Companies and Bodies Corporate, 29 February 1968, E.C. Bull. Supp. 2-1969, at 7.

[11] *Centros Ltd. v. Erhvervs- og Selskabsstyrelsen*, Case C-212/97, 1999 E.C.R. I-1459.

[12] *Überseering BV v. Nordic Construction Company Baumanagement GmbH*, Case C-208/00, 2002 E.C.R. I-9919.

courts denied the existence of the firm as a limited liability legal entity in line with the real seat theory. Finally, in *Inspire Art*[13] the court tested the compatibility of a Dutch law that imposed domestic legal capital rules on 'formally foreign companies' (De Kluiver 2004, pp. 123–5) with the Treaty. In all cases, the ECJ found the national restrictions on these firms' activities to be in violation of the Freedom of Establishment. After *Überseering*, it was clear that the real seat theory was dead, at least within the EU (e.g. Bachner 2003, p. 49). On top of this, *Inspire Art* precludes the Member States from passing laws analogous to the pseudo-foreign incorporation statutes that New York and California have.[14]

The major issue at stake here was legal capital. The Second Company Law Directive,[15] which was a centerpiece of the early harmonization programme, required that Member States establish a minimum capital, establish limitations on dividends and other returns of capital to shareholders as well as preemptive rights, and set up protective procedural requirements for capital increases and reductions as well as preemptive rights. The catch, however, was that the directive only applied to public limited liability companies but not private ones. In fact, the directive induced some Member States, notably the Netherlands, UK, and Ireland, to introduce or emphasize a distinction between these two legal forms more strongly in the first place (see Department of Trade 1977, p. 6; Schmitthoff 1978, pp. 45–6; Edwards 1999, p. 53; Grundmann 2012,

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[13] *Kamer van Koophandel en Fabrieken voor Amsterdam v. Inspire Art Ltd.*, Case C-167/01, 2003 E.C.R. I-10155.

[14] Cal. Corp. Code § 2115; N.Y. Bus. Corp. L. §§ 1317–1320. For details about the Dutch law and its relatively recent vintage origins, see De Kluiver (2004).

[15] Second Council Directive of 13 December 1976 on coordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of Article 58 of the Treaty, in respect of the formation of public limited liability companies and the maintenance and alteration of their capital, with a view to making such safeguards equivalent, 1977 O.J. (L 26) 1. The directive has been recodified as Directive 2012/30/EU of the European Parliament and of the Council of 25 October 2012 on coordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of Article 54 of the Treaty on the Functioning of the European Union, in respect of the formation of public limited liability companies and the maintenance and alteration of their capital, with a view to making such safeguards equivalent, 2012 O.J. (L 315) 74.

p. 207). While the Second Directive was initially proposed in 1970,[16] it was not adopted until 1976, by which time British and Irish company law experts had, to some extent, influenced it. While an extension to private limited companies had originally been envisioned in 1970 (Grundmann 2012, p. 208), it was formally studied in a report only in 1993 (Commission 1993). Many continental European legal scholars, particularly Germans, would likely have welcomed it (Edwards 1999, pp. 54–5; Grundmann 2012, p. 208; see also Lutter 1995, p. 207). Minimum capital requirements were the main issue in the debate about regulatory arbitrage in the 2000s (see Enriques and Gelter 2007, pp. 600–602).

2.3 Fostering Economic Integration

Finally, EU company law harmonization was also intended to serve purposes of industrial policy. Some of the earlier documents and statements express a concern that European firms were prevented by national borders from consolidating on a Continental scale, which is why the European Commission saw a need to facilitate cross-border amalgamations (Colonna di Paliano 1965, pp. 3–5; European Community 1966, pp. 6–7; Pipkorn 1972, p. 503). The Commission pursued this objective through two avenues. First, it attempted to achieve some level of harmonization in M&A law, in particular with the Third and Sixth Directives on mergers and divisions respectively.[17] While these applied only to transactions involving companies governed by the laws of a single Member State, not all Member States at that time even had rules permitting both mergers and divisions (Edwards 1999, p. 92). It was expected that a directive on cross-border mergers would soon follow, as harmonization of domestic rules would make it easier to achieve compromise (Edwards 1999, p. 92). In fact, such a directive was enacted only in 2005,[18] and there is still no directive governing a cross-border transfer of seat.

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[16] Proposal of 9 March 1970, O.J. 1970 (C 48) 5, COM (70) 232 final.

[17] Third Council Directive 78/855/EEC of 9 October 1978 based on Article 54(3)(g) of the Treaty concerning mergers of public limited liability companies, 1978 O.J. (L 295) 36. It has now been replaced with Directive 2011/35/EU of the European Parliament and of the Council of 5 April 2011 concerning mergers of public limited liability companies, 2011 O.J. (L 110) 1. Sixth Council Directive 82/891/EEC of 17 December 1982 based on Article 54 (3) (g) of the Treaty, concerning the division of public limited liability companies, 1982 O.J. (L 378) 47.

[18] Council Directive on Cross-Border Mergers of Limited Liability Companies, No. 2005/56, 2005 O.J. (L 310) 1.

The second pathway for economic integration was to be the European Company Statute or *Societas Europaea* (SE), which initially intended to provide a uniform company law across State borders. It was first proposed in 1959 (Sanders 1959), and a pre-proposal was on the table by 1966 (Sanders 1966). The Commission issued formal proposals in 1970,[19] 1975,[20] 1989,[21] and 1991,[22] but the final regulation[23] and directive[24] were passed only in 2001 (see in detail Edwards 2003, pp. 443–50). The idea had always been that an SE would come into existence only as the result of a cross-border transaction, such as a merger of companies from different Member States, or the foundation of a joint subsidiary. As a federal alternative to national incorporation with a merger procedure governed by supranational law, the SE would thus facilitate economic integration.

3. DISCORDANCE BETWEEN VARIETIES OF CAPITALISM IN TWO PERIODS OF FORMAL CONVERGENCE

3.1 Convergence and EU Company Law

The question for this chapter, however, is whether EU company law was rather an obstacle or a vector for convergence in corporate governance. When discussing convergence in corporate law, we would typically think

[19] Proposal for a Council Regulation embodying a Statute for European Companies (submitted to the Council on 30 June 1970). COM (70) 600 final.

[20] Proposal for a Council Regulation on the Statute for European Companies. Amended proposal presented by the Commission to the Council on 13 May 1975, pursuant to the second paragraph of Article 149 of the EEC Treaty, COM (75) 150 final.

[21] Statute for a European Company. Proposal for a Regulation on the Statute for a European Company. Proposal for a Directive complementing the Statute for a European Company with regard to the involvement of employees in the European Company (presented by the Commission to the Council on 25 August 1989), COM (89) 268 final.

[22] Amended proposal for a Council Regulation (EEC) on the Statute for a European Company, COM (91) 174 final.

[23] Council Regulation (EC) No 2157/2001 of 8 October 2001 on the Statute for a European Company (SE), 2001 O.J. (L 294) 1.

[24] Council Directive Supplementing the Statute for a European Company with Regard to the Involvement of Employees, No. 2001/86, 2001 O.J. (L 294) 22.

about in the context of the (late) 1990s and the 2000s. Capital markets were becoming more important for large firms, and various forces led to an increased orientation toward the interests of investors in corporations around the world. Observers of corporate governance have noted that corporate law has become more focused on shareholders, specifically outside investors. In this view, the idea of shareholder primacy as the prevailing goal of corporate governance radiated from the US and the UK. One prominent example is the spread of the corporate governance movement, inspired by the British 'comply or explain' model across Europe in the form of corporate governance codes (e.g. Siems 2008, pp. 56–9; Aguilera and Cuervo-Cazurra 2009, pp. 377–79). A number of legal reforms are also usually thought to fit that mould, including the German Control and Transparency Act of 1998, the French 'Nouvelles régulations économiques' of 2001, and the Italian reforms of 2004 (see e.g. Clift 2007, pp. 553–7; Enriques and Volpin 2007, pp. 127–37; Pargendler 2012, p. 2952). Institutional investors that diversified their holdings internationally (e.g. André 1998, pp. 76–83) as well as legal academics (Klages 2013) played a role in pushing for shareholder-oriented reforms.

Hansmann and Kraakman (2001, pp. 450–53) argue not only that the force of logic and example dictate the supremacy of the shareholder model, but also that larger trends such as more widespread share ownership and greater openness toward trade and competition across borders have helped to spread the gospel. The extent of convergence was and is subject to extensive debate. Inefficient institutions may inhibit convergence to optimal rules (Milhaupt 1998), and the forces of competition may be stifled by path dependence, for example of vested interest groups with political power that seek to protect their rents (Bebchuk and Roe 1999; Bebchuk 2003, p. 843). Moreover, it is widely acknowledged that 'convergence of form' and 'convergence in function' do not always go hand in hand (Gilson 2001). Functional but non-formal convergence means that institutions adjust without any formal change in the rules, e.g. because more shareholder-oriented practices are adopted without a compelling legal requirement. Formal but non-functional convergence refers to the situation where rules change, but the actual practice or outcome remains largely unaffected.

EU (or EC) company law fits into the convergence model in various ways. First, as is clearly evident, it has provided a vector for convergence far longer than the time period usually discussed in the convergence literature. However, as we will explore in the subsequent section, its original model was not the shareholder model espoused by the convergence literature. To the extent that EU rules diverge from this model, EU

law helped to entrench rules that many scholars would likely consider inefficient (e.g. legal capital) and not in line with the shareholder model.

Second, in line with the triviality critique of the directives, one could argue that often the directives only led to formal convergence. For example, the Fourth and Seventh Directives,[25] which governed accounting, left so many options that they allowed the Member States to largely leave their own accounting cultures as they were. The introduction of International Financial Reporting Standards for the consolidated accounts of publicly traded firms by the IFRS Regulation of 2002[26] was most strongly driven by the critique that financial statements across Europe were still not comparable after decades of accounting harmonization (Gelter and Kavame Eroglu 2014, p. 134).

However, at a certain level, EC/EU harmonization also has helped 'modern' convergence. Arguably, the 2002 report of the Winter group, which set the subsequent corporate law agenda, espoused a shareholder perspective,[27] as did the subsequent 2007 Shareholder Rights Directive.[28] Nevertheless, Hansmann and Kraakman (2001, p. 454), in their influential polemic regarding the 'End of History of Corporate Law' consider EU company law harmonization only a 'weak force for convergence', in part because harmonization has been difficult where there were considerable differences between the Member States, as we will explore in the subsequent section.

Another lens through which we can look at company law harmonization is the theory of different 'varieties of capitalism'. This literature originates in economic sociology (Hall and Soskice 2001), but has also

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[25] Fourth Council Directive of 25 July 1978 based on Article 54(3)(g) of the Treaty on the annual accounts of certain types of companies (78/660/EEC), O.J. (L 222) 11; Seventh Council Directive of 13 June 1983 based on the Article 54 (3) (g) of the Treaty on consolidated accounts (83/349/EEC), O.J. (L 193) 1. In 2013, both directives were re-codified as a single Accounting Directive. Directive 2013/34/EU of the European Parliament and of the Council of 26 June 2013 on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings, amending Directive 2006/43/EC of the European Parliament and of the Council and repealing Council Directives 78/660/EEC and 83/349/EEC, O.J. (L 182) 19.

[26] Regulation (EC) 1606/2002 of 19 July 2002, 2002 O.J. (L 243) 1.

[27] Winter et al. (2002), Report of the High Level Group of Company Law Experts on a Modern Framework for Company Law in Europe, Brussels, 4 November 2002.

[28] Directive 2007/36/EC, 2007 O.J. (L 184) 17.

been applied to (comparative) corporate law (Milhaupt and Pistor 2008). This literature distinguishes between liberal market economies, such as those of the English-speaking countries, and coordinated market economies, which includes Continental European ones. While the former are mainly based on competition and individual market transaction, the latter rely on strategic coordination through aggregated interest groups interacting with a long-term perspective (see also Johnston 2009, p. 143). In the corporate governance context, this distinction is linked to the more broadly accepted one between 'arm's length' or 'outsider' systems of finance on one hand, or 'control-oriented' or 'insider' financial systems on the other. While outsider systems rely on investors whose contributions are collected through a capital market, insider systems rely more strongly on concentrated relational investors, including controlling shareholders and bank lenders (e.g. Berglöf 1997, pp. 159–64; Dignam and Galanis, 2009, p. 43–4).

While at least some of the earlier steps of EU harmonization proved to be relatively innocuous, widely accepted changes in some jurisdictions, in other areas the process got caught up in a 'clash of capitalisms' (on the different models in the context of EU harmonization, see Dean 2012). On one level, if we look beyond company law harmonization, the EEC/EC/EU as a whole has helped to foster free trade, open markets, and competition. Openness to trade often has the consequence of upsetting national socio-economic arrangements and bargains between interest groups because of the introduction of foreign competition. Openness to competition tends to erode corporate rents, which, among other things, reduces the portion captured by employees (Roe 2001). European integration generally is often seen as a market-oriented project, and a good case can be made that the EU, as a whole, has helped convergence in corporate governance by fostering open markets, trade, and competition. This is evident from the case law rooted in primary EU law, namely the freedom of establishment cases discussed above (section 2.2 above) as well as the cases on Golden Shares (discussed below in section 3.3.1), which made it harder for national governments to influence the economy through corporate ownership. While primary law sought to eliminate national barriers, secondary law in the form of the directives often was intended to mitigate the effects of market forces. In the 'clash of capitalisms', while primary law tended to promote aspects of liberal capitalism, the initial harmonization program sought to preserve elements of coordinated capitalism, in some cases by raising them to the European level. The following sections will thus explore the two main periods of convergence and harmonization. In the first period, harmonization efforts largely had this effect, but increasingly faced resistance from liberal

Britain. In the second period, the situation reversed. Liberal capitalism and financial markets were in the ascendancy, and harmonization increasingly served that purpose, while pockets of resistance by capitalism's coordinated variety remained.

3.2 Krautrock: Stakeholders, Coordinated Capitalism, and the German Model in Traditional EU Company Law

As we have seen, the early EU company law harmonization project was partly driven by practical considerations, such as firms interacting with third parties. The more regulatory aspects on the agenda were at the time characterized by a typically Continental vision of the law, for which the Second Directive (discussed above in section 2.2) provides a good example. Conceptually, law could attempt to protect creditors from shareholder opportunism in a number of ways. It could set up *ex ante* safeguards, of which legal capital would be an example (even if many argue that it is not particularly effective in this capacity) (e.g. Armour 2000; Enriques and Macey 2001). Specifically, minimum capital could be called a form of merit regulation, i.e. only firms that are able to surmount that barrier are permitted to enter the market. This contrasts with disclosure-oriented creditor protection (see below section 3.3.1) or *ex post* liability for directors or shareholders (e.g. veil piercing).

The handwriting of the Continental regulatory approach can also be seen in operation in service of the goal of economic integration and cross-national mobility, namely the Third and Sixth Directives. These directives also exhibited the characteristic *ex ante* regulatory approach of EU company law in the form of disclosure and auditing requirements, and supermajority voting requirements for shareholders. The directives do not establish procedures for appraisal or revaluation, except that under certain circumstances a court or administrative body must be able to revalue compensation,[29] and creditors must be able to demand adequate safeguards.[30] The directives met resistance in the 1970s, and lengthy negotiations ended only after specific protections for employees were dropped (Grundmann 2012, p. 671). One peculiar aspect is that the UK could formally implement the directive, but it has in practice provided

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[29] Directive 2011/35/EU, art. 28(c).
[30] Art. 13.

other transactional forms that largely obviate the new firms from making use of the harmonized law (Enriques 2006, p. 42). Consequently, the operations governed by the directives are 'relatively unfamiliar' to UK lawyers (Edwards 1999, p. 91).

Maybe the clearest example is how the EEC struggled with harmonizing boards of directors of public limited companies, both in the SE (see section 2.3 above), but even more so in the planned Fifth Directive, which would have mandated a particular board structure and a distribution of powers between boards and shareholders across the Continent. The first draft for the directive was proposed in 1972[31] and amended in 1983,[32] 1990,[33] and 1991. The proposal was formally withdrawn by the Commission in 2001.[34] The Fifth Directive would have actually addressed corporate governance issues, a few aspects of which are now governed by the Shareholder Rights Directive of 2007[35] and the new Audit Directive of 2014,[36] but it stood out in its rigid German-inspired approach, which it shared with early drafts for the SE. In both cases, a two-tier board structure coupled with mandatory employee representation would have been required. Apparently, the Commission's goal at the time was to introduce labour representation in large companies across Europe (Pipkorn 1972, pp. 499–500). While the original SE and Fifth Directive drafts may have been viable proposals in the original six-member EEC,

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[31] Proposal for a fifth Directive to coordinate the safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of Article 58 of the Treaty, as regards the structure of sociétés anonymes and the powers and obligations of their organs, COM (72) 887 final, 27 September 1972.

[32] Amended proposal for a Fifth Directive founded on Article 54(3)(g) of the EEC Treaty concerning the structure of public limited companies and the powers and obligations of their organs, COM (83) 185 final.

[33] Second amendment to the proposal for a Fifth Council Directive based on Article 54 of the EEC Treaty concerning the structure of public limited companies and the powers and obligations of their organs, COM (90) 629 final.

[34] Communication from the Commission – Withdrawal of Commission Proposals which are no longer topical. COM (2001) 763 final.

[35] Directive 2007/36/EC of the European Parliament and of the Council of 11 July 2007 on the exercise of certain rights of shareholders in listed companies, 2007 O.J. (L 184) 17.

[36] See art. 37 of the Directive 2014/56/EU of the European Parliament and of the Council of 16 April 2014 amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts with EEA relevance, 2014 O.J. (L 158) 196 (requiring a shareholder vote for the appointment of the auditor).

the UK opposed them most fervently, but not after contributing to a domestic debate. The Labour government of the 1970s commissioned a report on employee representation that actually recommended employee participation (Bullock 1977). However, with only lacklustre, if any support from the unions (Marsh and Locksley 1983, p. 50; Wedderburn 1986, p. 837) it was not enacted before the Conservative Thatcher government came into power in 1980, which took the UK off the map in terms of employee representation. Generally, UK resistance against employee representation on boards is cited as a reason for the failure of the Fifth Directive (see generally Temple Lang 1975; Schneebaum 1982, pp. 308–17; Murphy 1984; Dine 1989; Johnston 2009, p. 137). Another corporate governance project based heavily on German law, the Ninth Directive on Corporate Groups, never made it past the stage of unofficial draft proposals (in 1974/75 and 1984) (Andenas and Woolridge 2009, p. 449–50; Grundmann 2012, p. 763).

A gridlock lasting 30 years regarding the SE came to a conclusion after lengthy negotiations only after compromise was reached on governance structure in 2001. First, the final SE Regulation largely abandoned the idea of providing a comprehensive corporate statute. The regulation touches upon only a few issues and refers to the national law of the State of registration to fill the gaps[37] (on the limited scope of regulation e.g. Enriques 2004, p. 77). Second, as to the contentious issue of board structure, Member States, which generally needed to pass implementing laws on SEs registered under their respective laws (even if the Union legislation took the form of a regulation), had to permit 'their' SEs to choose either a single-tier or a two-tier board structure. Arguably, this was a bigger leap of faith for Member States requiring two-tier boards for their domestic SEs such as Germany and Austria. Third, regarding employee participation, there is no one-size-fits-all solution for employee participation. When two companies merge to form an SE, the Directive on the Involvement of Employees[38] requires that employees elect a 'special negotiating body' to negotiate employee representation rights in the future SE on their behalf.[39] If no compromise is reached, default rules provide for employee participation provided that a certain minimum

[37] SE Regulation, art. 9.

[38] Council Directive Supplementing the Statute for a European Company with Regard to the Involvement of Employees, No. 2001/86, 2001 O.J. (L 294) 22.

[39] SE Employees Directive, arts. 3–4.

number of employees previously enjoyed such rights. While at first glance this system would seem to result in an expansion of participation rights in the case of international combinations, the fact that the SE is used mainly in jurisdictions that have employee participations rights belies this fact (Eidenmüller et al. 2009). In practice, the negotiated mechanism freezes employee participation at a particular level (regardless of whether a national size threshold is subsequently exceeded), and it apparently has allowed a number of German firms to switch to a one-tier system while slightly reducing the percentage of employee representatives. Finally, it may even be possible to eliminate employee representation entirely by merging the SE with a firm without employee representatives after a number of years (Gelter 2010, pp. 810–18).

Between 1984 and 2001, EC (EU) company law harmonization almost came to a halt. Only two relatively technical directives (on branch offices[40] and single-member private limited companies[41]) were adopted in 1989. In this period, European company law harmonization came to be seen to be in crisis or even as a failure. The recognition of the principle of subsidiarity in the Treaty of Maastricht may have further undercut the legitimacy of top-down harmonization (Grundmann 2004, p. 607). Several of the more controversial proposals were shelved, at least for a time, including Cross-Border Mergers and Transfers of Seat, the SE, and not least the Fifth Directive on Company Structure.

While EU company law harmonization thus led to some convergence in corporate law within the Union, it was not the kind of convergence associated with the 'convergence in corporate governance' period of the late 1990s and 2000s. When the earlier directives were enacted, German corporate law carried the greatest prestige, and at the very least, would have been the endpoint of convergence. If anything, European harmonization led to some convergence toward a Continental model for a time.

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[40] Eleventh Council Directive 89/666/EEC of 21 December 1989 concerning disclosure requirements in respect of branches opened in a Member State by certain types of company governed by the law of another State 1989 O.J. (L 395) 36.

[41] Twelfth Council Company Law Directive 89/667/EEC of 21 December 1989 on single-member private limited-liability companies, 1989 O.J. (L 395) 40, now recast as Directive 2009/102/EC of the European Parliament and of the Council of 16 September 2009 in the area of company law on single-member private limited liability companies, 2009 O.J. (L 258) 20.

While the initial six Member States shared a relatively similar outlook toward law and the economy, the accession of the UK, Ireland, and Denmark to the EEC in 1973 changed the trajectory of company law harmonization. The UK, now one of the largest and most vocal Member States, had at least some influence on EU law harmonization, but more importantly became a hindrance in a number of projects. Overall, fundamental differences in the outlook toward corporate law and governance between Member States had become too great (Armour and Ringe 2010, pp. 128–9). A last hurrah for German prestige in corporate law came in the early 1990s with the collapse of the Soviet Union and the disintegration of the Warsaw Pact. The newly capitalist countries looked to the West for inspiration in developing corporate law, and here the German model proved to be influential, in part because countries in Eastern Central Europe reverted to pre-communist traditions. Moreover, it should not be overlooked that Portugal and Spain had joined the EC in 1986, and Austria, Finland, and Sweden were newly admitted to the EU in 1995, which collaterally led to a geographic expansion of the application of the directives, even if these countries did not bring fundamentally different corporate law traditions to the table.

3.3 The New Wave: The Second Wave, Capital-market Orientated and Convergence in Corporate Governance

3.3.1 The ECJ and capital markets reinvigorate European company law

A number of developments helped propel EU company law harmonization back into action during the 2000s. First, the case law on the freedom of establishment (section 2.2) induced various important policy debates. It fuelled the debate about legal capital, which started to come under increasing criticism during the 2000s. As is evident from cases such as *Centros* and *Inspire Art*, the ECJ considered the benefits to creditors questionable, as did many scholars (e.g. Armour 2000; Enriques and Macey 2001) and the influential Rickford report, a British initiative against legal capital (Rickford 2004a). The cases led to a debate about regulatory competition, which was no longer only seen as a danger but also as an opportunity, at least by some, given the favorable view among some scholars (e.g. Armour 2005). In practice, it led to a temporary boom in the formation of pseudo-foreign private limited companies in England and Wales and eventually some 'defensive' regulatory competition regarding minimum capital, in particular a reduction of minimum capital to €1 at least in certain forms of business organization (e.g. Roth and Kindler 2013, p. 39; Conac 2015a, pp. 149–50). A number of

Member States maintained restrictions that clearly violated or disregarded the case law, while in others, foreign incorporations became a viable practical option (Becht et al. 2009). Logically, there would have been two steps for the EU to have taken in response. One choice would have been to reaffirm confidence in the Second Directive's scheme and eventually extend it to private limited companies, since this is where regulatory arbitrage was happening; given that legal capital is ostensibly intended to protect creditors first, there is no reason to treat public and private limited companies differently in the first place. The other policy choice would have been to give in to the criticism and repeal the Second Directive. However, the Commission did neither but proposed a re-codified version of the directive, which was enacted in 2012.[42]

Second, from the mid-1990s onward, the Commission had begun to challenge the so-called 'Golden Share' arrangements as violations of the free movement of capital. Golden Shares constituted legal or statutory rights for national or subnational governments to interfere in the governance of specific companies, e.g. through veto rights in privatized companies in key industries. In most cases, the court found them to be in violation of free movement of capital because of their effect of supposedly discouraging investment across borders (see Ringe 2010).[43]

The Golden Share case law, however, helped reinvigorate another controversial topic, namely the Thirteenth Directive on Takeovers, which had been an old project serving the objective of consolidating European industry across borders. Takeover law had first been taken up in the Pennington Report of 1974 and in the Commission's white book of 1975, and proposals were issued in 1989 and 1990, 1996 and 1997. Finally, the Member States almost reached an agreement in June 2000 under the

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[42] Directive 2012/30/EU of the European Parliament and of the Council of 25 October 2012 on coordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of Article 54 of the Treaty on the Functioning of the European Union, in respect of the formation of public limited liability companies and the maintenance and alteration of their capital, with a view to making such safeguards equivalent, 2012 O.J. (L 315) 74.

[43] *Commission v. France*, Case C-483/99, 4 June 2002; *Commission v. Belgium*, Case C-503/99, 4 June 2002 (only case where the national measure, which provided merely for a veto in specific circumstances, was upheld); *Commission v. Portugal*, Case C-367/98, 4 June 2002; among others, see also the subsequent 'Volkswagen' case of *Commission v. Germany*, Case C-112/05, 23 October 2007.

German presidency and would have implemented a non-frustration rule that prohibited boards of target companies from adopting defensive actions without shareholder consent (Hopt 2002, p. 9). Representatives of a number of German firms, particularly Volkswagen, personally intervened with Chancellor Schröder, which caused Germany to change its position. As the European Parliament also opposed the directive in its then draft form, the compromise, which the German Council presidency had previously carefully brokered, was off the table (Hopt 2002, p. 10). The commission subsequently rebooted the process by introducing a 'High Level Group of Company Law Experts' (Winter et al. 2002a) that in addition to the non-frustration rule proposed the breakthrough rule, which invalidates structural takeover defences such as restrictions on the transfer of shares and differential voting rights in hostile bids. However, the final compromise reached by the Member States – against the opposition of the Commission (Davies et al. 2010, p. 107) – made both the non-frustration rule and the mandatory bid rule optional for the Member States. They are permitted to allow firms subject to the non-frustration or breakthrough principle (either because of the country's law or charter) to apply the 'reciprocity' principle, according to which firms may avoid applying these principles vis-à-vis bidders that are themselves not subject to these rules. Thus, besides procedural and disclosure requirements, only the mandatory bid rule is mandatory in the final directive.

Another development that propelled the Takeover Directive forward was the Financial Services Action Plan of 1999,[44] which, given the practical prevailing fragmentation of securities markets, had four objectives: '(i) developing a single European market in wholesale financial services; (ii) creating open and secure retail markets; (iii) ensuring financial stability through establishing adequate prudential rules and supervision; and (iv) setting wider conditions for an optimal single financial market' (Armour and Ringe 2001, p. 152). In doing so, the EU passed a set of measures harmonizing in part substantive law, and in part conflict of law rules (Enriques and Gatti 2008, p. 48). Besides the Takeover Directive, which had been on the program for company law decades earlier, this program included in particular the Market Abuse Directive,[45] the Prospectus

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[44] Communication of The Commission, Financial Services: Implementing the Framework for Financial Markets: Action Plan, COM (1999) 232 final.

[45] Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation (market abuse), O.J. 2003, (L 96) 16. It has since been repealed and replaced by Regulation (EU) No 596/2014 of the European Parliament and of the Council of 16 April 2014 on Market Abuse (Market Abuse Regulation) and repealing Directive 2003/6/EC of the

Directive (recently replaced by a regulation),[46] the Directive on Markets in Financial Instruments (MiFID),[47] and the Transparency Directive.[48]

A further important related project was the overhaul of EU accounting law. The original Fourth and Seventh Directives were part of the company law harmonization program, and unlike financial reporting in US securities law, their objectives were not entirely oriented toward the capital market. The Fourth Directive especially was closely connected to the First and Second company law Directives and the idea of 'equivalent safeguards' for legal entities within the common market. By requiring all limited liability companies to disclose at least a limited set of financial statements, it implemented the UK idea of mandatory disclosure as the 'price' for limited liability (see Edwards 1999, p. 123 n. 41; Rickford 2004, p. 408; Schön 2006, p. 264), which met considerable resistance in some parts of the Continent, where initially large proportions of firms failed to file their statements (Edwards 1999, pp. 22–3; Enriques 2006, p. 14; Schön 2006, pp. 260–62) until the ECJ compelled Member States to enforce the

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European Parliament and of the Council and Commission Directives 2003/124/EC, 2003/125/EC and 2004/72/EC, 2014 O.J. (L 173) 1; Directive 2014/57/EU of the European Parliament and of the Council of 16 April 2014 on criminal sanctions for market abuse (market abuse directive), 2014 O.J. (L 173) 179

[46] Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC, O.J. 2003, (L 345) 64; recently replaced by Regulation (EU) 2017/1129 of the European Parliament and of the Council of 14 June 2017 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market, and repealing Directive 2003/71/EC, 2017 O.J. (L 168) 12.

[47] Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC, O.J. 2004 (L 145) 1. It has been replaced by Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU, 2014 O.J. (L 173) 349; Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012, 2014 O.J. (L 173) 84.

[48] Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonization of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC, O.J. 2004 (L 390) 38.

requirement more effectively.[49] At the same time, because the Second Directive tied the amount distributable as dividends to accounting, the harmonized accounting principles were shaped by the central purpose of not allowing excessive distributions (see Haller 1995, p. 236; Ferran 2006, pp. 200–201, 208-209, Enriques and Gelter 2007, p. 603; Gelter and Kavame Eroglu 2014, p. 139). Together with strongly developed book-tax conformity in some Member States, this led to a strong influence of accounting conservatism on financial results and a contamination of information objectives crucial to the capital market (Gelter and Kavame Eroglu 2014, pp. 146–7).

In the 1990s, the harmonization scheme of the two directives came to be widely perceived as a failure because financial statements from different Member States were still not comparable, and thus did not provide an 'adequate safeguard' for third parties interacting with companies. The Daimler-Benz 1993 cross-listing in New York and the firm's parallel use of US GAAP exposed that German accounting standards were maybe not as reliably conservative as people previously had thought, and pressure mounted for the EU to help firms to internationalize their financial statements, which eventually led to the IFRS Regulation in 2002.[50] Publicly traded firms must now use International Financial Reporting Standards in their consolidated financial statements. However, this did not result in a complete displacement of the directives, as Member States may allow or require non-publicly traded firms to apply harmonized domestic accounting legislation for both entity-level and consolidated accounts, and publicly traded firms for entity-level financial statements.

3.3.2 Shareholder rights and new legal forms

In the core areas of company law, the 2003 Company Law Action Plan (CLAP) set the agenda for the next decade.[51] Firmly rooted in a

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[49] *Daihatsu Deutschland v. Verband Deutscher Daihatsu-Händler*, Case C-97/96, 1997 E.C.R. I-6843; *Commission of the European Communities v. Germany*, Case C-191/95, 1998 E.C.R. I-5449. The court also had to deal with the question of whether mandatory disclosure was a violation of fundamental rights: *Axel Springer AG v Zeitungsverlag Niederrhein*, Case C-435/02, 2004 E.C.R. I-8663.

[50] Regulation (EC) 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the Application of International Accounting Standards, art. 5, 2002 O.J. (L 243) 1

[51] Communication from the Commission to the Council and the European Parliament: Modernising Company Law and Enhancing Corporate Governance in the European Union – A Plan to Move Forward, COM (2003) 284 final.

shareholder vision of corporate law and governance, and clearly exhibiting the handwriting of the corporate governance movement (Dean 2012, p. 473), its first major objective was creating minimum standards for shareholders in publicly traded firms. Citing the British Cadbury report, a number of the issues it raises are directly out of the 'good corporate governance' playbook, including stronger shareholder rights and 'shareholder democracy'. Regarding the board of directors, the model espoused by the Commission is no longer the two-tier system of the proposed Fifth Directive of yesteryear, but freedom of choice between different board models, combined with independent directors populating the nomination, remuneration, and audit committees typical of publicly-traded firms in the US and the UK.

The major product of the ensuing process was the Shareholder Rights Directive of 2007.[52] Applying to publicly traded companies only and intended to facilitate the exercise of voting rights across borders, among other things, it establishes the record date system favored by institutional investors, proxy and correspondence voting, and includes a number of other provisions intended to facilitate voting in other jurisdictions.

Other CLAP items include the Directive on Cross-Border Mergers, which was passed in 2005, and the Directive on the Transfer of Seat, which is still outstanding (on French resistance because of the fear of losing tax revenue, see Conac 2015, p. 224; on the plan generally see Wymeersch 2007). Beyond that, the Commission planned additional supranational legal forms, particularly the European Private Company or *Societas Privata Europaea* (SPE), which the Commission proposed in 2008[53] but withdrew in 2013 due to conflicts regarding employee participation, as well as the high degree of flexibility and possible absence of a minimum capital (Davies 2010, pp. 482–3, 487–9; Roth and Kindler 2013, p. 23; Teichmann and Fröhlich 2014, p. 537; Conac 2015, p. 221). The Commission followed up with a proposal for a European single-member company (*Societas Unius Personae* or SUP).[54] Based on

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[52] Directive 2007/36/EC of the European Parliament and of the Council of 11 July 2007 on the exercise of certain rights of shareholders in listed companies, 2007 O.J. (L 184) 17.

[53] Proposal for a Council Regulation on the Statute for a European Private Company, COM (2008) 396/3.

[54] Proposal for a Directive of the European Parliament and of the Council on single-member private limited liability companies, COM (2014) 212 final.

the Commission's 2012 Action Plan,[55] the SUP mainly serves the purpose of facilitating the establishment of subsidiaries in other Member States (Conac 2015a; on the action plan see Hopt 2015, pp. 151–3). The relative lack of formalities, which might be its strength by making the SUP an appealing legal form, is again a weakness of this proposal, given the opposition from Member States favoring a more regulatory corporate law (Teichmann and Fröhlich 2014, p. 537; Hopt 2015, p. 160).

At the time of writing, the most talked about topic is the adoption of major revisions to the Shareholder Rights Directive in 2017.[56] The amendments include a requirement for institutional investors and asset managers to disclose shareholder engagement policies as well as transparency requirements for asset managers and proxy advisers, as well as for companies' remuneration policies. Member States must provide for a say-on-pay vote, although it can be merely advisory. Maybe most interestingly, Art. 9c of the text requires that material related-party transactions shall be publicized, subject to a report by an independent third party, and approved by either shareholders or the supervisory or administrative body. Previous drafts for the amendment would have gone further and provided mandatory shareholder approval. Evidently, the final version was again the result of a compromise that took criticism into account according to which the rule was hardly compatible with German corporate governance, where outside shareholders can hardly be expected to be disinterested arbiters of related party transactions (e.g. Hopt 2015, p. 155; Tröger 2015, pp. 187–90).

Overall, the renewed activity in EU company law in the third millennium has an entirely different flavor than the original harmonization project. While compromises on a few 'traditional' projects were finally reached, most of the new measures are linked to capital market development. This is clearly true for the Takeover Directive, the Shareholder Rights Directive, and the IFRS Regulation, all of which apply only or

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[55] Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions: Action Plan: European company law and corporate governance – a modern legal framework for more engaged shareholders and sustainable companies. COM (2012) 740 final.

[56] Directive (EU) 2017/828 of the European Parliament and of the Council of 17 May 2017 amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement, 2017 O.J. L 132/1.

primarily to publicly traded firms, as well as the Audit Directive of 2006 with its enhanced requirements for publicly traded companies.[57] The issue animating the new directives was corporate governance, which, as a movement, swept Europe in the late 1990s (see generally Pargendler 2016, pp. 380–81). Most of the requirements came directly out of the emerging 'good corporate governance' playbook, in which the UK was *de facto* often seen as the model jurisdiction. While the UK did not, for example, actively promote takeover harmonization, the Commission's proposal clearly took it as a model. One might be tempted to suggest that the new model is characterized by attention to disclosure – in line with a capital markets vision – as well as decision-making by informed shareholders. This contrasts to some extent with the earlier attempts to impose a two-tier board system, when the influence of large shareholders was taken for granted and little attention was paid to outside investors. At least where publicly traded firms are concerned, it would probably be wrong to say that the new model is less regulatory than the old one. The Shareholder Rights Directive, for example, similarly attempts to establish minimum standards, but simply with a different orientation and purpose; the UK approach is not necessarily less regulatory than the German one, even if it regulates differently. Arguably, agreement on issues related to capital markets was easier to achieve than in core corporate law, given that in most Member States few firms actually tapped the capital markets and thus might have opposed reform (Armour and Ringe 2010, p. 157). This may help to explain why the current reform of the Shareholder Rights Directive was enacted. However, in the end, the reform is only relatively minor and again a watered-down compromise. Moreover, even in Germany, confidence about the desirability of measures proposed in the first wave of company law harmonization, such as the two-tier board and the German law of corporate groups and codetermination is far lower than in the 1970s or 1980s.

Regarding privately held firms, it is probably correct to say that a less regulatory, Anglo-Saxon approach is on the ascendancy. The contractual vision of the business organization, which is also evident in LLCs in the US, has been gaining ground in part because of *Centros* and its progeny. So far, the EU has done little to de-regulate its corpus of harmonized

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[57] Directive 2006/43/EC of the European Parliament and of the Council of 17 May 2006 on statutory audits of annual accounts and consolidated accounts, amending Council Directives 78/660/EEC and 83/349/EEC and repealing Council Directive 84/253/EEC 2006 O.J. (L 157) 87.

company law (with the exception of relaxed financial disclosure requirements for 'micro entities'[58]). For example, there has been no serious movement to follow the US lead in simplifying some requirements of the Second Directive that empower shareholders relative to the board, such as approval requirements for capital increases and decreases, or to eliminate preemptive rights. However, given the development of the past decades, it is at least unlikely that proposals to expand mandatory legal capital to private limited companies will ever be taken up again.

We can say, however, that Germany and the UK have reversed their roles with the advent of the new wave in European company law. In both periods, harmonization was typically a top-down project promoted by the Commission and company law experts seeking to fulfil the promise of a fully developed common market. There was usually no particular interest group or Member State that pushed for harmonization,[59] but the source of inspiration (i.e. the model that would be used to achieve this goal) changed. Whereas the old harmonization was largely based on Continental ideas that the UK resisted, the new, capital market-oriented projects were based on UK ideas that Continental European countries tended to resist, although not always with the same motivation. This can be seen most clearly in the Takeover Directive. Germany opposed the non-frustration rule because it would have shifted power away from boards (and employees) toward shareholders, in particular, in firms that might have been open to a takeover bid. In the Nordic countries, if the breakthrough rule had been made mandatory, it would have been hard to sustain a system where controlling (family) shareholders are traditionally seen as guarantors of good corporate governance (Hansen 2012, p. 39).

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[58] Directive 2012/6/EU of the European Parliament and of the Council of 14 March 2012 amending Council Directive 78/660/EEC on the annual accounts of certain types of companies as regards micro-entities, 2012 O.J. (L 81) 3.

[59] An exception may be International Financial Reporting Standards, which were very desirable for large firms seeking to internationalize their shareholder base, as well as large accounting firms that sought to expand their share in the audit and consulting markets.

Among the Member States, clearly the UK provided the model for the Takeover Directive, but the UK government was not particular enthusiastic about the directive because it meant that the previously self-regulatory panel would have to put on stronger legal foundations (Clarke 2007, p. 384).

4. CONCLUSION

Throughout all periods, EU company law harmonization was largely a top-down, technocratic project that was considered imperative to realize the common market. In other words, it was promoted mainly by the European Commission and experts advising it without any particular business or investment interest group pushing for harmonization.[60] However, that does not mean that it has been entirely without effect on national corporate laws. Hansmann and Kraakman (2001, p. 454), in their influential polemic regarding the 'End of History of Corporate Law' consider it only a 'weak force for convergence', in particular because it often does not always conform to the shareholder-oriented model, but also because harmonization has been difficult where there were considerable differences between the Member States.

We have seen that EU company law harmonization has always been in the balance between centralized top-down proposals coming from Brussels, and varying national resistance. In the early period, when company law harmonization was influenced mainly by Continental models, the UK stepped on the brakes after joining the EEC in 1973 (e.g. Johnston 2009, p. 139), whereas since the 2000s, when the UK law dominated as the model, Germany and other Continental jurisdictions have been the main force of resistance. This change was driven largely by which model of corporate law was considered preferable. Because of Member State options and the ability to avoid company rules, in many areas, convergence has remained formal and superficial, but not entirely irrelevant.

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[60] Arguably, an industry of lobbyists, technocrats, and advisers (including lawyers and legal academics) may thus have benefited most from harmonization (Enriques 2006, pp. 55–9).

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PART III

ASIA

13. Corporation law in late Imperial China

Teemu Ruskola

According to received wisdom, there is no such thing as a Chinese tradition of corporation law.[1] As Max Weber summed it up, "The legal forms and societal foundations for capitalist 'enterprise' were absent" in traditional China" (1968: 85). John King Fairbank's more recent restatement of Chinese history could well have been written by Weber: "The nondevelopment of Chinese law along lines familiar to the West was plainly related to the nondevelopment of capitalism and an independent business class in China. There was no idea of the corporation as a legal individual. Big firms were family affairs." (1992:185–6)

Although this claim is intuitively appealing, it is incorrect, or at least wildly exaggerated. This chapter argues that in late imperial China there existed a tradition of "corporation law," to use a term that admittedly sounds anachronistic. Conventional wisdom to the contrary notwithstanding, and despite Confucian hostility to commerce, even before the introduction of European law at the turn of the century the Chinese operated "clan corporations," or relatively large commercial enterprises organized in the guise of the family.

CORPORATION LAW IN COMPARATIVE CONTEXTS

It is important to begin by noting that because of their different intellectual environments, traditional Chinese and contemporary American corporation law have faced distinctive conceptual and socio-political problems. We live in a legal system that happens to think in terms of "persons." Consequently, an important task for Anglo-American corporation law has been to justify the existence of collective entities, such as corporations, in a way that accords with liberal individualism. Ultimately every legal actor must be a "person," no matter the conceptual violence. This requirement has bequeathed us the legal fiction of the corporation as a "person" in its own right. Today, after endless arguments about the

[1] This chapter is an abbreviated adaptation of my article on 'Conceptualizing Corporations and Kinship.' See Ruskola (2000).

nature of corporate personality, American corporation law has finally abandoned further metaphysical speculation: in Bayless Manning's tart words, we have worked our way "out of the platonic murk accumulated over two thousand years" (1962:245). A recent U.S. theory of the corporation takes this process to its final, logical conclusion: it thoroughly "individualizes" the corporation by conceptualizing it as nothing more, or less, than a "nexus of contracts" among its individual constituents.

In contrast, in the Confucian view the collective was morally prior to the individual. Hence, for traditional Chinese law collective legal personality was a given. The main problem for Chinese business enterprises was the anti-mercantile attitude of orthodox Confucianism and its general ideological hostility to profit-seeking. The idealized Confucian view posited a radical isomorphism among the family, on the one hand, and the larger political and social communities on the other: they were all governed by a similar kinship logic. Given that one is not supposed to take advantage of family members, Chinese corporation law has focused on justifying to the state the *type* of collective that in fact seeks profit at the expense of others – and then divides its profits unevenly among various classes of members/owners/workers. Hence clan corporations' relentless insistence that they were simply extended families: status as a kinship group entailed legitimacy and recognition by the state. Coincidentally, this also meant that these clan corporations were governed ultimately by family law, which in turn implied fiduciary duties by clan leadership to clan members.

Finally, it may be useful to state briefly what this chapter is *not* saying. There is a venerable tradition of Western scholarship that focuses on the role played by the family in China. From the beginning, Western legal observers – from Montesquieu to Hegel and others – have commented extensively on the prevalence of familial analogies in Chinese social life. Either expressly or implicitly, these traditional accounts – and their many contemporary variations – suggest a contrast between an idealized "West" where the individual is the authentic political and metaphysical subject, and a despotic "Orient" where the collective reigns supreme in affairs familial and political. The self-serving contrast between a stationary East of witless myrmidons and a progressive West of self-sufficient individuals has indeed generated one of the enduring clichés of comparative law – namely, that the former are frozen in categories that delimit Status while the latter define their own relationship through Contract (Maine 1861:165).

This chapter, too, focuses on the remarkable role played by the rhetoric of family and kinship in Chinese legal and economic organization, but rather than recycle Orientalist myths about China's unique, essential, and

enduring nature, I hope to challenge the received colonial epistemology on which such analyses rest. For one thing, the fact that the Chinese household owned collective property and engaged in the pursuit of profit hardly differentiates it from its counterparts elsewhere. Indeed, the very word "economy" comes from the Greek root *oikos*, "household." Rather, what is unique about the history of Chinese legal and economic organization is the vehement *ideological* insistence on kinship as the organizing principle – even in the case of large clan corporations in which kinship was the most threadbare fiction and many of the governing relations *in fact* originated in contract, not kinship. In China, as probably everywhere else, family businesses were among the first types of business organizations, yet even Chinese enterprises that were *not* family businesses often chose to present themselves as such.

DEFINING CORPORATION

To arrive at a legal conceptualization of traditional Chinese "clan corporations," this chapter draws on two areas of Sinology: kinship anthropology and legal history. That Chinese clans often owned property jointly to provide for clan welfare and ancestral sacrifices has been well documented by several generations of anthropologists. Much of the scholarship analyzes families and clans in terms of the ritual significance of their kinship practices. Importantly, Hill Gates has offered an interpretation of late imperial clan organizations as primarily commercial enterprises organized on the sociological foundation of the family (Gates 1996). Building on Gates' thesis and giving it a specifically legal dimension, this chapter shows that clan corporations' vehement insistence on kinship as their organizing principle did not mean that they were "just" family affairs. Rather, kinship was often a finely wrought legal fiction that legitimated the existence of private enterprises by profit-seeking individuals in a state in which Confucianism was the official orthodoxy.

In Felix Cohen's blunt verdict, to seek to discover the "true" nature of the corporation is transcendental nonsense: what the corporation "is" depends on the purposes we attribute to corporation law (Cohen 1935). However, there is a consensus among treatise writers on several conventional criteria: (1) limited investor liability; (2) freely transferable ownership interests; (3) legal personality; and (4) centralized management. In addition, business corporations have two other features that are relevant in transposing the concept onto traditional Chinese clan organizations: they are (5) voluntary associations; and (6) formed for the purpose of

pursuing profit (in contrast to some of the other major species of the corporate genus, such as municipal corporations and non-profit corporations).

However, these features are largely formal and in practice frequently compromised. For example, often promoters of a new corporation have to provide personal guarantees to obtain credit, while closely held corporations frequently restrict the free transfer of shares and their management is not even necessarily separated from ownership. In fact, many argue that close corporations are "really" incorporated partnerships, not true corporations. As ideal types, corporation and partnership constitute two distinct ways of organizing capital. Real-life variations aside, the archetypal partnership is one in which the investors are able to control and monitor their investment directly. This, presumably, is why close corporations are seen as a mutant representative of the business corporation, not the real thing. Indeed, Robert Clark tells us that "the single most important fact about corporate law" is the separation of ownership and management. (Clark 1986:130) This lies at the heart of the classic agency problem, which has defined American corporation law and theory for the better part of the twentieth century: if managers are merely "agents" of the shareholders – the true owners of the corporation – how can we ensure that the managers will in fact manage the corporation in the shareholders' interest, rather than their own? Put simply, why should investors trust the managers to guard their capital and use it productively?

Although I argue below that clan corporations certainly had most – possibly all – of the formal characteristics of the corporation, I rely on this formal definition only provisionally. Hoping not to get mired in legal semantics, I am ultimately interested in identifying analogous enterprise forms in traditional China, not exact equivalents (clearly an impossibility).

PROTO-CORPORATE CHARACTERISTICS OF CHINESE HOUSEHOLDS

The traditional Chinese family provided the prototype of what would evolve into a clan corporation. As a kin group celebrating its patrilineal continuity, it was indeed a "perpetual" corporation in its ritual aspect. However, the continuity of the traditional household was limited to the performance of ancestral sacrifices: as far as household property was concerned, it characteristically dissolved at each generation.

In a sense, all traditional Chinese law was "family law" – or, perhaps more accurately, applied family law. Much as in our legal culture contract constitutes the dominant paradigm of private ordering which is then

projected onto the public sphere as a "social contract," so family was the paradigmatic governance model in Confucian social and political thought. With the eventual emergence of neo-Confucianism as state orthodoxy in the Song and Ming, the family was given a metaphysical foundation and filial piety was promoted to cult status.

It is hence hardly surprising that the ideology of patrilineal kinship provided a prototype for the clan corporation as well. In a form of ritual primogeniture, in each family the eldest male of the most senior line inherited the primary responsibility for ancestral sacrifices. In this respect, the Chinese family was indeed a (men's) "corporation" in the sense in which the nineteenth-century comparativist Henry Maine used the word: "Corporations never die, and accordingly primitive law considers the entities with which it deals, i.e. the patriarchal or family groups, as perpetual and inextinguishable" (Maine 1861:126). Indeed, the family was a welfare system like no other: in theory at least, it extended from cradle to grave *and* beyond. Mencius – the early Confucian second only to the Master himself – exhorted, "Keeping one's parents when they are alive is not worth being described as of major importance; it is treating them decently when they die that is worth such a description" (Lau 1970:4.B.13). The *Classic of Filial Piety* maintains that even one's body is not one's own, but belongs to parents (Fung Yu-lan 1952:361). A father in turn is obligated to provide for his young "not so much because he owes it to the youngsters, but because he is obligated to their common ancestors" (Hsu 1948:240).

The notion of a personal continuity between fathers and sons was not merely metaphysical. Exemplifying the perpetual corporate nature of the patriline, a man's male offspring inherited both his assets *and* liabilities, even when the latter outweighed the former. As a perhaps even more striking example of interpersonal continuity in the patriline, consider the following 1910 account of a conversation taking place before a county magistrate's court:

> 'I bought this land and now Tung family is trying to steal it from me," complains a petitioner. "When did you buy it?" asks the magistrate. "Two hundred years ago," promptly replies the oppressed one. Says another, "My rights to the property of Sung Lien-teng are being contested by my cousin. I am the rightful owner. I buried Sung Lien-teng and have charge of his soul-tablet [for ancestral worship] and carry out the ancestral ceremonies." "When did Sung Lien-teng die?" questions the magistrate. "In [1701 in] the fortieth year of K'ang Hsi," is the reply.

(Johnston 1910:140) What could this exchange possibly *mean*?

> [It] means that the deceased whose property is in dispute died childless in 1701, that plaintiff's ancestor in that year defrayed the funeral expenses and acted as chief mourner, that by family agreement he was installed as adopted son to the deceased and heir to his property, and that plaintiff claims to be the adopted son's descendant and heir. Looking upon his family, dead and alive, as one and indivisible, he could not see any practical difference between the statement that certain funeral rites had been carried out by himself and the statement that they had been carried out by a direct ancestor.

(Johnston 1910:140) To say that the plaintiff could not see *any* practical difference between actions by himself and those of his ancestors is surely an overstatement, but he clearly thought that whatever the difference was, it should have been *legally* irrelevant, in light of the continuity of the patriline.

The Confucian metaphor of kinship as a membership of the dead, alive, and unborn in "one body" gave rise not only to ritual continuity of the family but also to an incipient separation of ownership and management functions – the feature most characteristic of the modern business corporation. In the orthodox Confucian view, kinship relationships are paradigmatically hierarchical, with the kin senior exercising authority over the kin junior. The father-son relationship for example, was governed by the master principle of *xiao*, or filial piety. Early comparativists typically read into *xiao* the Roman concept of *pietas* and its correlate *patria potestas*, paternal power, which indeed left those under *potestas* under the father's mercy and certainly with little recourse to the law for protection (Möllendorff 1896:41; Parker 1897:68). However, at least in terms of Confucian political theory – as opposed to political practice – this is an incomplete description. The ideal of domestic – and political – harmony does not result from the observation of hierarchy alone: parental and political power must be tempered by concern for those whom one governs. In the characterization of the contemporary philosopher Tu Wei-ming, the ideal Confucian society was a "fiduciary community" in which the "corporate effort" of the entire membership turned the group into "a society of mutual trust instead of a mere aggregate of individuals" (Tu 1976:67, 81).

When this moral hierarchy was projected on the household economy, it had profound material implications. In the strictly Confucian view membership in the lineage descended in the male line only. Ritually speaking, women were in effect non-persons, mere begetters of (male) persons. Since all household property was owned by the undivided patrilineage to which women did not belong, they held no rights of their own to lineage property (although they did have the right to be supported by their male kinsmen). The undivided ownership of lineage property

among men reflects in turn the ritual understanding of the patrilineage. As the legal historian Shuzo Shiga explains the father-son bond, "during the father's lifetime the son's personality is absorbed into the father's, while after the latter's death his personality is extended into that of his son. Father and son are a *continuum of the same personality*, not two beings in mutual rivalry" (Shuzo Shiga 1978:119 emphasis added). In this light, it made perfect sense that the father had no testamentary powers over the household property: it was not *his* personal property.

Given that the father was in effect under a duty to leave the property to his sons, his position has often been likened to that of a trustee for his heirs. An alternative conceptualization is to view him as the *manager* of the "household corporation," in which capacity he owed a fiduciary duty to the shareholders in the corporation. Thus, the classic agency problem posed by this separation of the management and ownership was solved – in good Confucian manner – by the imposition on the family head of a duty not to waste or unlawfully alienate collectively owned property. In a schematic fashion, traditional Chinese family law indeed mirrored the structure of modern American corporation law.

To be sure, this "fiduciary duty" of Chinese family law was not statutory, but a customary rule. It applied in many, if not all, locales in Qing China. According to an official report on Taiwanese customary law, it was "indispensable" to obtain the signatures of close male relatives on deeds when selling land: "The only reason for such a practice was that an immovable was regarded as a property of the family and the signature of a relative apparently was evidence of his approval of the transaction" (Okamatsu 1902:35–6). Similarly, on the other side of the realm, in the northern Shandong province at the turn of the century, it was customary in land sales for "numerous relatives" to sign the title deed "as proof that all is in order" (Johnston 1910:143). In a sense, these signatures constituted a shareholder authorization for the sale.

But even if the ritual continuation of the patriline was potentially perpetual, the ownership of family property was not. The Qing Code expressly mandated equal inheritance among all sons at each generation, which usually ensured the dissolution of even the largest fortunes relatively quickly; the proverbial duration of the Chinese riches-to-rags story was three generations. This result was hardly coincidental, and certainly to the liking of the imperial state, which was at least as suspicious of large concentrations of private capital as nineteenth-century United States was during the rise of the business corporation.

Indeed, when it came time to divide up the household property, contract law took priority over the laws of ritual kinship: household

division (*fen-jia*) was not simply a "natural" process of property descending in the patriline, but a distinctly contractual procedure. When the sons of one late nineteenth-century Taiwanese household went their separate ways and set up independent households, the household division contract framed the event in terms of the essential corporate unity of the family: "[E]ven a tree with deep roots and many leaves must branch forth, and a running stream cannot avoid having tributaries. So it is only *natural* to expect that our family eventually must partition" (Chen and Myers 1978:8–9). Even though the rhetoric of partition contracts employed organic metaphors to emphasize collective unity in kinship, this rhetoric cannot hide the unpleasant fact that the contracts were in fact drawn up to settle conflicts over property among individual family members. In practice the fiduciary bonds of kinship usually turned out to be only so strong as the legal unity of property. According to contemporary reports on customary law, once property was divided among brothers, "even though some of them may be unfortunate enough to get poor, the other brothers will not help him" (Okamatsu 1902:xxv).

In short, although the family provided a simple model for the governance of jointly owned property, that property did not partake in the perpetual nature of the patriarchal kinship structure. Ironically, while Confucian officialdom was eager to promote the ritual rather than economic aspects of kinship, in their attempts to encourage the maintenance of ancestral worship they coincidentally provided the kin group with a means to protect its corporate property from dissolution: the institution of ancestral trust.

FROM HOUSEHOLD TO ANCESTRAL TRUST

The ancestral trust made two major contributions to the evolution of clan corporations: it provided the family with a means of perpetual ownership of property as well as an institutional structure in which managers were selected by the clan rather than genealogically determined. With familism reaching a fever pitch in the Song period, the emerging neo-Confucian synthesis called for a renewed commitment to the principles of patriarchal kinship. The leading neo-Confucians encouraged families to maintain elaborate genealogies out of respect to ancestors and to ensure their continued worship. Taking this advice to heart, many successful imperial officials created charitable trusts for the property they had accumulated over the course of their careers. In these trusts, the property was to remain intact over generations and their income was to be used for ancestral halls for worship as well as welfare funds providing grants to

needy members of the family. To the extent a trust's income allowed it, it could also be invested legitimately in cultivating cultural capital in the form of educating promising young males – in the hope that they might one day attain success in the examination system and thus bring glory (and prosperity) to the clan. As the patriline multiplied over time, membership in the trust came to constitute an extended kin group identified by the titular ancestor: a clan (*zong* or *zu*).

The ancestral trust set up by the Song statesman Fan Zhongren in 1049 provided the historical prototype and the instructions for its administration were cited frequently in the Ming and Qing. Fan's original instructions provided for a manager and listed criteria by which the manager was to distribute the trust proceeds to various clan members. Fan also provided a general statement of fiduciary duty: "Should the manager make any wasteful expenditure or make advance payments to anybody, the branches [of the clan] are permitted to review the matter and force him to pay an indemnity." Apparently the trust instructions were not always followed, for in 1064, the clan head requested official recognition of the trust by the throne and asked for permission to bring any offending clan members before the local magistrate for trial. The state happily granted this privilege to further a righteous clan's attempts to provide for the spirits of their ancestors. Indeed, the trust was accorded even preferential tax treatment. Alas, apparently the trust continued being mismanaged; in 1083 the instructions were again supplemented, now establishing a full-time salaried manager and providing for specific penalties for the violation of each rule (Twitchett 1959: 106–119.).

Ancestral trusts were thus safe both from extractions by the state because of their unquestionable political correctness, and from dissolution at each generation because of their perpetual nature. However, this very success posed its own problems. As clan membership multiplied and the number of beneficiaries grew over time, a trust's ability to pay for its ritual and welfare functions decreased correspondingly – unless, of course, proceeds from the trust estate were reinvested profitably in commercial pursuits. In fact, what better way could there be to serve one's ancestors than to work to increase the size of the clan estate? The practice of investing the trust's proceeds was a natural, even inevitable, outgrowth of the basic logic of the institution. Reflecting their increasingly mercenary nature, the instructions of many ancestral trusts came to separate completely the qualifications of managers from their genealogical status: in selecting managers, clan members were to focus on criteria such as "honesty, wealth, and capability" (Wang Liu 1959:106). The ancestral trust was thus well equipped to become a business corporation with separate ownership and management functions.

FROM ANCESTRAL TRUST TO CLAN CORPORATION

Many ancestral trusts were no doubt just what they purported to be: relatively small charitable trusts the proceeds of which were spent more or less exclusively on ritual, educational, and welfare expenses of the clan. However, in terms of both their institutional organization and their activities, many ancestral trusts are usefully viewed as business corporations, rather than merely ritual properties of "natural," extended families. I analyze the corporate nature of such trusts in terms of the provisional definition sketched above: I suggest that: (a) ancestral trusts were often voluntary associations rather than natural kin groups; (b) their "bottom line" was the pursuit of material profit rather than satisfaction of the needs of ancestral spirits; (c) they possessed the functional elements of independent legal personality; and (d) their management was centralized. Whether clan corporations fulfill the last two parts of the formal definition is somewhat more tendentious, but there is evidence that, at least sometimes: (e) ownership interests in the corporation were transferable; and (f) the enterprises had limited liability.

(a) Voluntary Associations or Kin Groups?

The idea that clan corporations were really voluntary associations for private profit-seeking is utterly counterintuitive; surely Chinese clan members did not "choose" their kin any more than any one of us "chooses" our family? Indeed, if the modern American corporation is a "nexus of contracts," kinship is the ultimate status regime – and the distance between the two presumably measures the progress from "Status to Contract" (Maine 1861:165). However, although many clan corporations presented themselves as trusts set up by a distant ancestor, in fact they were often contractual arrangements formed posthumously by their member-owners. Indeed, the idiom of the family was frequently only a legal fiction used to recruit workers/members, many of whom were not even related by blood to the clan they joined.

In the standard anthropological view, clans with ancestral estates divided into segments – *fang*, or branches – by a natural process of fission: the ancestor who created the trust became the focal point for his descendants, who became his beneficiaries and were entitled to trust proceeds on a *per stirpes* basis. However, recent studies suggest that the segmentary model is largely an idealization of actual kinship practices. Often, it was the desire to pool capital that brought a clan into being by transforming the abstract notion of kinship into a self-identified corporate

entity: participating kinsfolk would select a long-dead ancestor, in whose name they set up a posthumous "ancestral trust" to hold the capital.

As an example, witness the following contract whereby over 200 kinsmen from four separate branches of a family came together to create an "ancestral trust" for distinctly commercial purposes:

> Makers of this contract Kuan Chi-shan [13 other names given, all of the Kuan surname] and others, are uncles, brothers and nephews within the [clan] who have lived separately … In the Jen-shen year of the Ch'ung-chen reign [1632], the four [branches of the family] came to an agreement to donate on a per capita basis towards an ancestral trust, to put out capital [*pen*] to seek a profit [*li*]. … Sacrifice was held for several years, and as there was no disagreement, in the Ting-ch'ou year [1637], the silver donated individually and the amounts left after paying sacrifices, totaling over 80 teals, were used for the purchase of a shop in Sung-kang market. … Subsequently, a plot of land for planting rice seedlings was purchased from Kuan Ch'en-chao, head of the street [on which the market is located], payment for which was made from the same ancestral trust. The land so purchased will be rented out to tenants and the rent collected is to be used for sacrifice. Sums of money left after paying for sacrifice are to be saved in preparation for the building of the ancestral hall and used in connection with sacrifice.

(Faure 1989:351–2) The contract goes on to make it absolutely clear that, for the purposes of this "ancestral trust," the relevant kin group is defined monetarily: "The 212 people who have donated have not done so in the name of [their branch of the family] and winter sacrifices are of no concern to those [non-contributing family members] whose names are not listed." Conversely, states the contract, "any person who is to pay .38 tales according to our regulation may have his name listed in the book of the ancestral trust" (Faure 1989:352). To be sure, the contract professes concern with the provision of ancestral sacrifices. However, if ritual rectitude were truly the sole motivation for the trust, a proper sense of solidarity would seem to argue *against* the exclusion of non-contributing kinsfolk.

One might expect that even if the origins of some ancestral trusts were tainted by the cold contractual logic of commercial enterprise, ultimately familial solidarity and fiduciary obligations to one's kin would likely result in the "collectivization" of clan capital. Again, evidence supports the opposite conclusion. As a case in point, in 1751 one single-clan Hong Kong village organized a trust in honor of one of its ancestors who had died centuries earlier. At the time, the trust was based, as in the above example, on both descent from the titular ancestor and monetary contributions to the trust. One group of clan members refused to contribute, and, indeed, over 200 years' later, in 1977, the outside group's descendants were still not considered members of the clan corporation, nor were

they entitled to the material benefits of its membership (Rubie Watson 1985:32–4). Such a clan is clearly as much a creature of property as of kinship. In fact, there was a real tendency for property to *define* the right to claim kinship: some clans simply "sloughed off" the poorer branches from the clan genealogy, which effectively excluded them from sharing in the proceeds of corporate property (Meskill 1970:142). In a real sense, as one historian puts it, "the editing and printing of a genealogy created the organized kinship group rather than vice versa" (Meskill 1970:141).

Although the notion that "kinship" in a clan corporation was as much a property relationship as a genealogical one flies in the face of state Confucianism, at least in the above examples kinship was a necessary, though not always sufficient, requirement for membership in a clan corporation. However, in many corporations kinship was simply a fiction. The most extreme example of this is the merger of two or more unrelated clans. Given that there are fewer than 500 family names in China, it was not uncommon for unrelated clans in the same locale to have the same name. Relying on the ancient myth that those with the same family name descend ultimately from the same ancestor, unrelated clans with the same name that wanted to combine their capital for business would simply invent a long-dead shared ancestor to whom they started sacrificing (Hsiao 1960:353).

Of course, even if one was willing to disregard whether those with the same surname where related or not, the random distribution of surnames still often failed to coincide with commercial interests. However, at least in south-east China, there appeared to be simply no genealogical obstacle that could not be overcome by creative contracting. Consider, for example, the resourceful Li Bang. In the early eighteenth century, he combined five unrelated Fujianese families into a single unit with a new surname: the Li, Chen, Su, Zhuang, and Ke families suddenly became a new "kinship group" called Bao. This stunning corporate reorganization quickly spurred a group of rival clans to consolidate in the form of another novel entity, entitled Qi. That the new entities indeed functioned under the guise of kinship is evident in the fact that "contemporary writers quite consciously used the terms *hsing* [surname], *chia* [family], and *tsu* [clan] interchangeably" in characterizing the mega-clans (Ng 1983:31). In light of such heterodox practices, it is no surprise that concerned eighteenth-century provincial governors were already memorializing the emperor about "ancestral" trusts where the only qualification for participation was a monetary contribution: actual kinship was simply irrelevant (Hsiao 1960:353).

The fictive nature of kinship was most obvious when unrelated clans combined, but fictions abounded even in one-clan corporations which

often adjusted kin relations legally in order to recruit more human capital and labor. The adjustments were made by contract – most notably, marriage and adoption contracts – but even servants who could not be fitted into the genealogies were treated as quasi-family.

Despite Confucian admonitions to the contrary, adoption was an important and oft-used legal device for rearranging kinship relations contractually. As an extreme example of promiscuous adoption practices, one late sixteenth-century genealogy recorded nearly 300 adoptions, which certainly suggests that adoption was an important means of redistributing human resources in traditional China (Waltner 1990:90). Although in theory Confucianism frowned on adoption, at the same time for orthodox Confucians there was no worse infraction than filial impiety, and not having offspring was considered the worst form of filial impiety, for it meant that one's ancestors would have no one to continue making sacrifices to them and they would remain unworshipped ghosts. In situations where one otherwise would not have had a male descendant to continue one's line it was therefore permissible to adopt a son. Yet even in such cases, custom strictly prohibited adoption of non-agnates, except when no agnate was willing to provide a son. Indeed, official genealogies invariably professed grave concern regarding unorthodox adoption practices – although not necessarily for Confucian reasons. To the extent that having a son meant an extra person in the household who held a claim to a share in the lineage's common resources, it was understandable that clan rules provided penalties for reporting the birth of a fictitious son or the adoption of one with a different surname. Nevertheless, unorthodox adoptions certainly took place; in the blunt conclusion of a recent study, "The central paradox of adoption in traditional China is that adoption across surname lines was prohibited and that the prohibition was ignored" (Waltner 1990:138).

Adoption illustrates also the ambiguous relationship between the clan corporation and its male members. On the one hand, males were the "owners" of the clan, or at least its property (which, in so many ways, included its women). Indeed, to maintain accurate "shareholder registers," some clans had a "New Male Book" which listed both births and adoptions (James Watson 1980:229). On the other hand, men were also clan property in the sense that they belonged to the clan. But because poorer clans could not always afford to keep their human capital, it was possible for the more prosperous clans to buy more males in the form of adoptive son-in-laws.

Orthodox Chinese marriage was virilocal: when a woman married, she left her family and joined that of her husband. However, in practice uxorilocal marriages in which the husband joined his wife's family were

far from uncommon. The usual fiction for legitimating these marriages was the adoption of the son-in-law, often as a young boy who was to marry one of his new "sisters" upon maturity. According to a report on customary law near Nanking in the late Qing, "People who have no male children usually bring in a son-in-law to act as their son. On entering the family the son-in-law changes his name, and a contract is written so there will be proof" (Wolf and Huang 1980:12). The economic aspect of the transaction was evident: to have his son-in-law entered in the genealogy and accorded the rights of a successor, and thus ultimately part-owner of the clan property, the adoptive father was required to pay a fee to the clan. That this represented a material acquisition is fully evident in the adoption contracts whereby the transfers were accomplished: they specified the price of the adoptee, the sellers guaranteed title (by representing that the adoptee had not been kidnapped or obtained illegally), and assured that if something should "happen" to the child later, this was of no concern to the sellers. (For a sample contract, see Great Britain Mui Tsai Commission 1937:134.) Model contracts were freely available and could be copied from popular handbooks – with rather innocuous titles such as *The Complete Set of Domestic Rites*. Girls, too, were sold, albeit at lower prices and less reluctantly; in areas with high demand for light labor, up to three-quarters of girls were adopted out as infants to be raised as future daughter-in-laws (Wolf and Huang 1980:233). Put simply, despite Confucian cautions against the adoption of non-kin, adoption practices were in fact governed "not by the rules of kinship, but by the rules of the marketplace" (Wolf and Huang 1980:204).

Marriage was probably the single most common means of recruiting female labor into clan corporations: wives and concubines were, in many ways, bought and sold in the market for productive and reproductive labor. Indeed, whatever else traditional Chinese marriage was, it was preeminently a contract, "with its central economic features either written down or clearly recognized" (Gates 1996:122). Among the central economic features of any marriage were dowry and bride price, the former an expenditure by the bride's family and the latter, the groom's family. As Gates notes, "Without her dowry, a bride ran the risk of being told she came as a beggar, stealing resources for her own upkeep from a husband's family" (Gates 1996:123–4). However, in practice many marriages entailed a net expenditure by the groom's, rather than the bride's, family, thus reflecting the net gain in obtaining the value of the bride's labor (Gates 1996:126).

Not only did clan corporations buy women as brides and infant daughters-in-law, but sometimes also as maid servants, as the highly ambiguous term *mui tsai* is usually translated. Although these girls were

"bought and sold as chattels," even they were absorbed into the familial idiom of the clan corporation, and, despite their servitude, often were allowed eventually to marry out (James Watson 1980:243–4; Great Britain Mui Tsai Commission 1937:22). The so-called tenant/servants (*dian pu*) inhabited a similarly ambiguous social location. Especially in areas with a shortage of labor, wealthy clan corporations contracted with poor tenants who agreed not only to cultivate their land but also to hereditary labor obligations. Although legally the tenant/servants occupied a low status, within the clan corporation they were considered quasi-kin: contractual violations were viewed as "unfilial," they were often mentioned in the clan genealogies, and, indeed, they were even provided with burial places in the clan corporation's ancestral cemetery (Mi Chu Wiens 1990).

In short, given the evident plasticity of Chinese kinship practices, much as Chinese kin groups may have wished to present themselves *as* kin groups, one must always ask whether a particular clan constitutes "a unilineal descent group or a voluntary association posing as a unilineal descent group" (Rubie Watson 1985:35). The closer one looks, the more the clan corporation begins to look like a "nexus of contracts" among self-interested, profit-seeking individuals, and the less like Confucian familism writ large.

(b) For Profit or Ancestral Glory?

Orthodox state Confucianism was infused with an anti-commercial spirit. While wealth surely mattered in its own right, by far the most socially acceptable road to success was winning a post in the imperial bureaucracy. The state recruited its officials through the prestigious civil service examinations, whose content had formed the neo-Confucian orthodoxy since the eleventh century. Many successful merchants in fact legitimated their success by buying degrees and thus purporting to become members of the gentry class, from which scholar-officials were drawn. In this (ostensibly) unfavorable political climate, the ideological usefulness of the ancestral trust lay in its claim to provide for the posthumous worship of a clan's forebears. From the Confucian perspective, it was thus not morally suspect private property for selfish purposes, but a means of perpetuating family solidarity. Nevertheless, clan corporations were analogous to business corporations not only because of their frequent origin as voluntary associations, but also because of the profit-seeking activities in which they engaged. Effectively, they contradict the traditional view that extended family organizations were the effect rather than the cause of prosperity.

Indeed, many ancestral trusts hardly functioned like trusts. Insofar as they purported to be charitable trusts for the purpose of providing ancestral sacrifices in perpetuity, their property was theoretically inalienable. In practice, this was simply not the case. Despite the sacred bonds of kinship and even express trust instructions to the contrary, ancestral trusts could in fact be dissolved by consensus and the properties (including ritual lands held by the trust) divided among the beneficiaries (Hsien Chin Hu 1948:67). Similarly, ritual land could be used for clan members' private benefit in times of need, even in locales where this may not have been in accordance with "strict custom" (Okamatsu 1902:144). To make a sale of trust property valid one only had to recite on the sale deed that the sellers were "in want of means" – usually a "mere fiction," as one observer remarked (Jamieson 1921:30). At least in Hong Kong, even this fiction may not have been necessary: according to the colonial government's report on Chinese customary law, sales were permitted so long as they were "profitable" (Hong Kong Commission on Chinese Law and Custom1948:35).

The need to shroud all mercantile activity in high-minded Confucian rhetoric makes it difficult to judge in retrospect of just what any particular clan associations' activities consisted. However, there is increasing evidence to support the contention that Qing clans ran their estates as "hard-nosed business corporations" rather than Song-style charitable trusts (James Watson 1982:602). Absentee landlordism was one of the more lucrative economic activities for many Qing clans. One city-dwelling Taiwanese clan indeed boasted that the rents from its rural landholdings supported 400–500 clan members (Allee 1994:93). By Qing, commercialized agriculture was already well established, and rice, cotton, mulberry, sugarcane, and tea, among others, were all important cash crops, and, as Philip Huang has shown, the "familization" and commercialization of rural production proceeded in tandem in the Ming and the Qing (Huang 1990). Indeed, clan activities were hardly limited to land. By some estimates gentry families' income from trading and financial activities in the late nineteenth century was up to two-thirds of the income from land (Chang 1962:197). The well documented Lin clan in nineteenth-century Taiwan, for example, held its assets in a complex web of individual accounts, trusts, and partnerships, and its activities ranged from landlordism and urban real estate to money-lending, manufacturing, and camphor-trade (Meskill 1979:242). Around the same time, in certain regions there were family-run silk-weaving enterprises, some of which employed dozens of workers. The considerable scale of clan business is evident also from the fact that as late as the 1960s, income from clan corporations run by the wealthier rural clans in Hong Kong

was sufficient to permit clan members not to work for a living (Potter 1970:128).

As the historian Susan Mann observes, by the late imperial era the clan organization was not driven simply by wealth drawn from traditional gentry activity and bureaucratic positions; rather, "it could be sustained by either gentry or merchant activities, or preferably both" (1987:23). Conceptualizing clan associations as business organizations legitimated by their elaborate written genealogies explains also "the puzzlingly high level of genealogy-making at a time when kinship bonds had been thought to be weakening in the wake of modernization, especially in coastal China" (Meskill 1970:143). There is no puzzle: with increasing modernization and commercialization, there were a growing number of clan corporations. That the genealogies themselves made no mention of commercial activities is to be expected: as late as 1948, the anthropologist Francis L.K. Hsu noted that "[genealogical] records emphasize the importance of scholarship and official ranks as achievements, but fail completely to mention trading or commerce," which were nevertheless "the backbone" of everyday life (Hsu 1971:236). Or, as Mann trenchantly characterizes the stylized biographies provided by most genealogies, "no one knows how often 'filiality' served as a historical gloss on the lives of entrepreneurs who lacked any other printable distinction" (1987:90).

(c) Centralized Management

In most corporate scholars' view, the separation of management from ownership and the resultant agency problem constitute the key features of the modern business corporation. In the traditional Chinese family, the ritual structure of kinship indeed provided for the ownership of family property by the entire patriline and its management by patriarchal authority. Building on this simple model of corporation law, ancestral trusts *cum* clan corporations created increasingly complex and bureaucratic governance structures which included professional full-time managers, accountable to the "shareholders" in semi-annual meetings, and boards of elders whose task it was to monitor the managers in the interim.

The eldest male of the eldest line occupied technically the highest position in the clan hierarchy, but his leadership was usually mostly symbolic. Other senior members constituted a council, analogous to a board of directors, which, at least in the case of larger clan associations, left the actual clan management to various corporate officers; managerial authority was thus distinct from ritual authority. Even the rules of the exemplary Fan clan, generally held to embody neo-Confucian familism

at its best, contain an express rule providing that, in the management of clan affairs, managers' authority trumps that of their genealogical elders (Twitchett 1961:13).

As to their social status, managers were usually *literati* members of the clan; large clans, especially those with highly organized clan associations, were almost invariably economically and socially stratified. In the case of smaller clan corporations, by-laws usually call for the various segments (*fang*) of the clan to rotate the day-to-day management of their affairs annually among the *fang*-heads. In more complex organizations, the clan rules provide for a full-time salaried manager, sometimes with assistants, as well as auditors, registrars, and other functionaries (Twitchett 1961:30; Hsien Chin Hu 1948:84).

Ordinarily, clan corporations held "shareholder meetings" open to the entire membership twice a year, in conjunction with the ancestral sacrifices in spring and autumn. At the meetings, after the sacrificial rituals were completed, the clan's attention turned to financial and administrative matters. The clan membership's role in the selection of corporate officers was often unclear. Short on procedural guidelines, clan rules might advise the clan "to select carefully," "for members to choose publicly", or "for members to recommend unanimously" (Wang Liu 1959:116). Although real instances of "direct democracy" were possible (Hsiao 1960:332), the prevailing preference for decision-making by consensus made it possible for leading factions of the clan to manipulate the outcomes. (This, of course, hardly makes the clan corporation any *less* like a modern business corporation, where shareholder meetings are often no less than ritualistic window-dressing.)

Mindful of the agency problem, clan corporations had various types of specific rules designed to keep the managers and other corporate officers honest, and also to keep other powerful members of the clan from interfering with the officers' work. Among typical requirements for managerial office were integrity and social status, as well as wealth – apparently on the assumption that the wealthy would be less tempted to steal, or possibly because it would be easier to obtain restitution from them in the case of embezzlement. Sometimes the managers were required to give bonds before assuming office. As to account-keeping, regulations required managers to make financial reports at clan meetings, the account documents had to be posted in the clan hall where meetings took place, and archives of accounting records were kept (Wang Liu 1959:84, 106, 148).

(d) Legal Personality

In a purely technical sense, Weber and his followers are of course correct in denying the existence of the concept of "legal person" in traditional China. However, in the context of traditional Chinese law, the observation misses the point. It is perfectly clear that family collectives could sue and be sued as well as own and dispose of property in a corporate capacity; in important ways, clan corporations were able to function in the manner of Western legal persons.

That the imperial state never conferred the legal abstraction of "personality" on clan corporations reflects the Confucian social epistemology in which the family was the most fundamental, real, and indeed natural unit. In many ways, the family *was* the Confucian "natural person," just as the individual is the "natural person" of modern Western legal systems. The personality of corporate entities has been a conundrum for *our* legal system because it happens to "think" in terms of individual persons. "The endless problem of corporate personality" (Radin 1932) plagued European and Anglo-American jurisprudence for distinct historical reasons, not because it is somehow inherent in the very notion of collective entities. As Thurman Arnold observes, "When the actual world is not at variance with men's belief, it is unnecessary to write or think much about it. When symbols or beliefs have no relation to what men see before them, regularity of doctrine becomes of paramount importance" (Arnold 1937:192). Because of its different foundational assumptions, traditional Chinese law required no jurisprudential alchemy to accommodate collectives as "real" entities: the theory of the indivisible patriline on which Chinese kinship is founded makes corporate personality the normative ideal, and individual personality the deviation.

Indeed, just as the logic of our legal epistemology has forced us to personify – or, more precisely, individualize – all legal subjects (every right and duty must be held by a "person," no matter the conceptual violence), so traditional Chinese law constantly sought to analogize everything within its purview to the family, as much the privileged subject of Confucian justice as the individual is that of Western political thought. The imputation of "familyhood" then resulted in the creation of artificial, or "legal" families, along with the "natural" kind. For example, when 13 sailors were slain off the coast of Fujian in 1828, the offense was likened to that of killing several members of one family since all the victims had served aboard the same ship (Edwards 1980:257–8). Similarly, in a case appealed to the Board of Punishments, the Board decided that two merchants who traveled together and pooled some of their resources constituted a "family" (*jia*) in a legal sense (Bodde and Morris

1967:193–4). As an extreme example of familism at work, even the legal relation between a madam running a brothel and the women working under her was often that of a mother and her adoptive daughters (Gronewold 1982: 38–40). Indeed, to conform to the ideology of the family, even eunuchs who were successful in their careers took *pro forma* wives and adopted sons for the purposes of succession (Möllendorff 1896:13–14).

In sum, by virtue of its status as a kinship group – real or artificial – the clan corporation acquired some of the ideologically unimpeachable and legally cognizable personality of the family. Even if the social universe was ultimately a unified whole, the family provided a legitimate means of partaking in that universal source of personality.

(e) Transferability of Ownership

Transferability of ownership is the corporate characteristic most difficult to identify in the structure of the clan corporation. Nevertheless, in limited ways printed copies of the clan genealogy functioned in the manner of stock certificates: in many clans, each member household was given one numbered copy of the genealogy, and at least in larger clan corporations, distributions of clan proceeds would be made only on presentation of a registered copy of the genealogy. The existence of clan regulations providing penalties for those who sold their genealogies suggests that there was at least a small market for the sale of shares in large clan corporations (Hsien Chin Hu 1948:51–2), and there are reports of instances where shares were sold to non-kin (Cohen 1993:163; Faure 1989:353). Nevertheless, there is little evidence of wide transferability of ownership in clan corporations, which obviously provided limits to their ability to raise capital – no matter how creative and ingenious they were in their ability to turn potential, biologically unrelated contributors into "kinfolk."

(f) Limited Liability

Just as the market for clan shares was limited, it is not quite clear to what extent clan corporations enjoyed limited liability. Part of the difficulty in defining limited liability in the clan is also conceptual. It is not clear just what it would mean for clan members to have unlimited "individual" liability for corporate acts. At least under the preferred Confucian theory of the family, family members owned no individual property: whatever property a person acquired, that property belonged to the family as a whole. Recent scholarship suggests, however, that individual property

could in fact co-exist with jointly-owned household property. As far as individually acquired property was concerned, the household head was permitted to disinherit his heirs or to devise his property to non-relatives by gift, for example. Insofar as any of his sons contributed to the acquisition of new household property, they had the right to demand division of that property at any time. Arthur Wolf and Chieh-san Huang indeed maintain that, in practice, the division of property would often in fact "respect individual effort and not flow directly from genealogical status" (Wolf and Huang 1980:60). To the extent that there existed individually held property of this sort, distinct from family property, there was at least the possibility of limited liability in the family and the clan. At a minimum, the British colonial administration in Hong Kong interpreted Chinese customary law so as to provide for limited liability: when the Partnership Ordinance of Hong Kong was amended to provide that an ancestral trust may register as a legal person with limited liability, it was the stated purpose of the British to bring the Ordinance in line with actual Chinese custom (Jamieson 1921:129).

CORPORATION LAW IN ACTION

Having reconstructed the official norms of traditional corporation law, it is time to consider how well, or whether, the fiduciary duties implied by the Confucian family metaphor were observed in actual corporate governance. Despite the conventional view that most clan disputes were resolved through intraclan mediation, clan members did in fact invoke the law to protect their rights and at least sometimes magistrates were willing to enforce them. In Northern Taiwan, for example, challenges to the illegal sale of common property could be initiated by male clan members who had been minors at the time of the sale. With remarkable frequency, even widowed women plaintiffs asserted rights to clan property as representatives of their minor sons.

That fiduciary obligations were the aspirational norm is clear. As one fifteenth-century observer put it, clan members should "treat each other 'as parts of a single body, like bone and sinew, hand and foot,'" and clan resources should be shared accordingly, with "no wealthy and no poor families." Yet it is equally clear that this ideal remained frequently unrealized: "the constant inroads made upon the common property by powerful [male] clan members" were among clan corporations' most egregious failures (Twichett 1959:132). Although clan regulations often provided expressly that no-one, of whatever genealogical rank, was above

corporation managers' authority, in practice managers were often susceptible to pressure by powerful clan members.

Yet even if Confucian "corporation law" failed to redeem its promise in full, that failure is not – at least not necessarily – merely the result of cynical abuse of power by those in higher echelons of the social hierarchy. Part of the problem lies in the very conceptualization of radical, organic unity in the family. Understood in terms of the Confucian metaphor of the family as "one body," the family head is virtually infallible: in a body, the head may well rank over the limbs and make decisions on their behalf, yet it is difficult to conceive that the head would purposely try to take advantage of the limbs. By definition, what benefits the head accrues to the benefit of the rest of the body as well. Or, as Justice Black rephrased Blackstone's dictum, even though in marriage "husband and wife are one person," "the one is the husband" (*United States v. Yazell* 361). Similarly, even if members of the Chinese clan were "one body," more often than not the "ones" were really the literate, well-placed members of the family.

For a Confucian who takes seriously the family metaphor and the notion of collective unity it suggests, the concept of self is best conceived as "interpersonal." By definition, this self is an altruistic one: "As a member of society the person must subordinate his selfish desires (*si yu*) to the good of the community or the public good (*gong*). His true personhood is thus achieved by disciplining his desires so that they serve rather than conflict with the public good" (de Bary 1983:24). A selfless concern for other members of the larger body is the very fulfillment of authentic personhood. Indeed, true filiality is realized "only if one's filiality is expressed not as an obligation toward an outside authority but as an integral part of one's self-realization" (Tu 1976:77).

The radical unity of the family, as expressed by orthodox neo-Confucian ideologues, made it effectively an oxymoron to "steal" from one's family: looting an ancestral trust was tantamount to trying to steal from oneself. Witness the words of reproach of a magistrate condemning a clan elder's attempt to divert clan property to his own uses:

> This was foolish, for his grey hairs were many; he was like a burnt-out censer at night when day is about to appear; little earthly enjoyment was before him, and *dead he would not have lost the property*, for if he died without children, would he not in the next world have fared with the rest of ancestors – sharing alike with them the common provision for their spirits?

(Alabaster 1899:594 emphasis added) By stealing from the ancestral trust, the foolish old man was simply stealing from his future spirit. From this perspective, the imperative that clan corporations be managed for the benefit of the living *and* the dead was eminently sensible, and in fact provided a perfect incentive for long-term planning; while it is undoubtedly true that "in the long run we are all dead" (Keynes 1923:80), a clan manager will be able to reap the fruits of "selfless" management even generations later.

That the family, for social and legal purposes, was likened to one body meant that intra-family exchanges were often impenetrably ambiguous. Although the Confucian fiduciary community was based on an assumption of reciprocity even among unequals – care and concern for those below in return for their submission – its key values of loyalty and filial piety "enjoined inferiors to keep giving to superiors even when no reciprocation was possible," in Hill Gates's crisp formulation (Gates 1996:45). With respect to the internal structure of the clan corporation, kinship ideology legitimated the intra-corporation division of labor and ownership by making hierarchy an ostensibly *natural* function of familial relationships, much like the "nexus of contracts" metaphor of contemporary corporate jurisprudence renders it *voluntary*. In a truly contract-based corporation all participants in the venture – from the chairman of the board to the lowest-ranking employee – will have agreed to their positions in the corporation.

FROM YESTERDAY TO TODAY

Recovering the story of corporation law in late imperial China is important in its own right. It matters also because, as I argue more extensively elsewhere, the familial idiom has continued to influence Chinese economic organization even after the official abolition of the traditional legal system (Ruskola 2000, 2014). Throughout the twentieth century, the several attempts to transplant Western corporation law in China were remarkable mostly for their irrelevance, whereas the family itself has continued to maintain a distinctive legal status – not unlike the one it enjoyed in the late imperial era – and the Chinese have continued to take advantage of that status in organizing their businesses. At the same time, state-owned and collective entities have often conceptualized along the lines of familial analogies: communities with shared collective interests, rather than contractual arrangements among self-seeking individuals with radically divergent aims. Moreover, just as traditional clan corporations were considered an organic part of the larger community, so

Chinese socialist enterprises have been expected to serve, or at least pay lip-service to, several constituencies in a similarly collectivist spirit.

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14. The stakeholder approach to corporate law: a historical perspective from India

*Umakanth Varottil**

INTRODUCTION

Existing literature in the fields of law as well as economics has offered a number of theories that help illuminate the concept of the company as a legal entity (Stout 2017). But, when it comes to determining the nature and purpose of the company, two competing theories stand out, and deserve greater attention. They are: (i) the nexus of contracts (or contractarian) theory; and (ii) the stakeholder theory (Choudhury and Petrin 2016).

The nexus of contracts theory views the company as a network of contracts that govern the relationships between various actors who get together to produce goods and services by forming the company (Tjio, Koh and Lee 2015). Proponents of this theory argue that a company structure is driven by private ordering among parties, and that there is no place in this discourse for public policy considerations, which ought to be dictated by exogenous public legislation (Easterbrook and Fischel 1991). This reemphasizes the nature of a company as a private body that is governed by principles of private law. Related to this is the fact that the contractarian perception of company law stresses shareholder primacy and the need for management to strive towards shareholder value maximization. In other words, shareholders are the primary constituents who receive the protection of company law, which relegates the interests of the other stakeholders to the back seat.

On the other hand, the stakeholder theory views the company's activities as affecting society in general. Hence, the company is said to possess a social or public character. For the same reason, company law may extend beyond the private realm and focus on the protection of

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non-shareholder constituencies such as the creditors, employees, consumers, the environment and the community. Moreover, the role of a company's directors is pluralistic in that they are not merely to maximize shareholder value but also to take into account the interests of the other stakeholders, without necessarily preferring one to another (Afsharipour 2017).

While this debate continues unabated, history could likely provide some lessons in refining the issues. With this background, the purpose of this chapter is to examine the historical evolution of corporate law in India from the first corporate legislation in 1850 until the present in order to assess the manner in which such legislation has addressed the question of corporate purpose. Such evolution straddles the colonial period until 1947 when Indian companies' legislation largely replicated parallel English legislation, and the post-colonial period when Indian corporate law began to deviate from its English origins in several aspects (Varottil 2016a).

As this chapter demonstrates, early companies' legislation in India during the colonial period largely treated a company as a private matter (similar to the nexus of contracts theory) with limited focus (if at all) on non-shareholder constituencies. This was consistent with the role of management in ensuring shareholder value maximization. This can be attributed to England's own focus in that direction at the time. However, in the years following decolonization in 1947, the purpose of the company began undergoing a metamorphosis with greater prominence being given to the public nature of the company and the impact of its actions on society. After a brief oscillation in the approach in the 1990s, recent reforms in corporate law culminating in the enactment of the Companies Act, 2013 have firmly ensconced the company within the framework of the stakeholder theory, and away from a pure shareholder maximization approach advocated by the nexus of contracts theory. The reasons for this sea change in approach are embedded in the political economy of the country, especially in the years following independence.

Section I briefly explores corporate lawmaking in India during the colonial era, which essentially represents a transplantation of English company law into India. During this period, there was scant focus on stakeholder interests, and company law was essentially for the protection of private interests. Section II shows that in the immediate period following India's independence, there was no significant change in the philosophy of company law when it came to the nature and purpose of a company. As Section III shows, the change began to occur during India's socialist phase commencing in the 1960s when company law began partaking a public character due to material amendments made to the

companies' legislation. Section IV analyses a minor course correction during the post-liberalization era in the 1990s when shareholder value regained primary focus, at least temporarily. But, as Section V discusses, stakeholder interest took on centre stage in the recent reform process culminating in the Companies Act, 2013. Section VI delves into the contemporary legislation and considers its evolution not only since the colonial period, but also in comparison with the origin country of England and finds significant divergence on matters of corporate purpose. Section VII concludes.

I. CORPORATE LAW DURING THE COLONIAL ERA (1850–1947)

The origin of the corporate structure can be attributed to the establishment of the East India Company (EIC) in 1600, which was achieved by way of a royal charter. The EIC had a monopoly to trade in India, although subsequently other companies too received similar privileges to carry on trading in India (Harris 2005). Interestingly, the Government chartered these companies for public purposes rather than for private profit (Stout 2017). Hence, considerations of private profit maximization did not appear to have been on the horizon.

Although chartered companies had carried out business activities in India since the EIC's incorporation in 1600, specific companies' legislation was to appear only in 1850 with the enactment of the Registration of Joint Stock Companies Act. This was premised on the English Companies Act, 1844. Thus began an era when Indian companies' legislation merely adopted the prevalent English legislation. Consequently, English company law reforms were promptly followed by similar reforms in India. This position continued until 1947 when India gained independence from Britain.[1]

It would be useful to consider the underlying economic and social factors that led to a transplant of English company law into India during the colonial period. Two trends have been attributed. First, the motivation for the transplant of English law was to promote British business interests in India rather than to protect the interests of any other constituencies. It was felt that symmetry in corporate legislation between England and India would facilitate trade and investment between the two countries, as

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[1] For a detailed analysis of the companies' legislation from 1850 until 1947, see Varottil (2016a).

it would introduce a sense of familiarity to British business interests in India (Rungta 1970). While this approach protected private British interests (i.e., those who were trading and investing in India), it did little to assuage the concerns of the local population (Birla 2009).

Second, transplanted English legislation operated in India through market regulation, a phenomenon that has been referred to as 'colonial laissez faire' (Birla 2007). Since the law was intended to benefit British businesses in India, it followed a free-market approach. This also tied in well with the prevailing ideology in Britain at the time. As Birla (2009) notes:

> I would like to reconsider the performance of colonial sovereignty, this time as a staging of market actors and as an implementation of a certain kind of colonial laissez-faire, manifest in legal frameworks standardizing the 'free circulation' of credit and commodities, most especially in the institutionalization of the law of contract as operative mode for market exchange.

In examining the corporate purpose during the colonial period, both the above factors point strongly towards the nexus of contracts theory. Company law was considered to be enabling in nature and to promote private interests. There was no mention whatsoever of other stakeholders. However, seeds of change began to be sown following India's independence in 1947, to which this chapter now turns.

II. THE EFFECT OF INDIA'S INDEPENDENCE ON CORPORATE LAW (1947–60)

During the post-colonial period, India underwent significant changes in its economic policies, which were driven by various political imperatives of the time. However, despite a major shift in the economic policies, India's corporate law did not witness a significant change in the way in which it viewed the nature and purpose of a company. To a large extent, the status quo was maintained immediately following decolonization.

A. Economic Policies Following Independence

Economic policy-making in the period immediately following independence turned out to be challenging. There was a sense of aversion towards capitalism given that the laissez-faire policies of the colonial Government were blamed for the impoverishment of the Indian economy and its population when the British retreated from the country (Tripathi and Jumani 2007). At the same time, there were significant differences within

the leadership of a free India. For instance, Jawaharlal Nehru (who eventually went on to become India's first Prime Minister) embraced the model of Fabian socialism in which the state was to play a prominent role in business. However, others in Nehru's Congress party, such as Vallabhbhai Patel (who went on to become India's Home Minister) called for liberal economic policies to maximize investment and production. Ultimately, the Government began implementing the policy for a 'mixed economy' (Tomlinson 1993). Private business groups thrived during these years along with direct participation by the state in industry.

At the same time, the Government introduced a number of measures to regulate industry. The Industries (Development and Regulation) Act, 1952 imposed licensing requirements whereby industrial units were required to obtain governmental licences before they began operations or even expansions of capacity (Tripathi and Jumani 2007). Similar restrictions were imposed on capital issues, foreign exchange transactions, and imports and exports of certain products. All of these created distorted incentives, and led to rent-seeking, which witnessed the growth of the 'licence Raj' that became dominant in the Indian economy (Tomlinson 1993).

These economic and political developments immediately following independence are instructive not only in analysing the effect of corporate law during the period, but also on reforms that ensued in the decades thereafter.

B. Corporate Lawmaking in Post-Colonial India

In the light of the significant changes in India's economic policies, one may surmise that its company law would undergo similar changes to meet with the ideology of the times. However, that was not to be. Independent India's first legislation in the field, the Companies Act, 1956, stuck to the path adopted in previous companies' legislation enacted during the colonial period.

Although India had the opportunity to chart a new course in company law, the legislators decided to keep up with equivalent English developments. In considering reforms, the Government appointed a committee under the chairmanship of C.H. Bhabha, which conducted an extensive study before proposing specific reforms for a new companies' legislation. However, the committee's recommendations were largely in line with the English Companies Act of 1948 (which was in turn the product of the Company Law Amendment Committee in England, known as the Cohen Committee). Such an approach meant that India displayed faithful adherence to the laissez-policy that English law continued to follow. This

was despite the economic policy tides turning quite strongly away from free-market regulation.

At one level, this curious outcome might seem rather inexplicable. At the same time, it has been argued that this might be due to compromises that the Government had to make between various views regarding economic policies (Tomlinson 1993). While the company law retained a largely contractarian approach consistent with the free-market ideology, the increased state involvement in industrial activity incorporated the socialist approach (Tripathi and Jumani 2007).

Overall, although the Indian Parliament had the opportunity to chart a new course for Indian company law given the radical changes that were being implemented in economic policies and other economic legislation, it decided to retain the status quo with regard to the purpose of the company. Private interests continued to hold sway, and there was still no word about stakeholder interests. But, that was to change in the ensuing period, to which I now turn.

III. THE RISE OF SOCIALISM IN INDIAN CORPORATE LAW (1960–91)

Although the Government's economic policies began shifting towards socialism soon after independence, the impact of this move on corporate law began taking effect only in the 1960s. Despite the approach of the Companies Act, 1956 to adopt the previous laissez-faire ideology, the legislation began undergoing significant amendments after the 1960s, primarily as a result of recommendations made by several committees appointed by the Government during the period. This was often in response to corporate scandals, which led to greater and more intrusive regulation of business by the Government (Varottil 2016b). All of this led to the infusion of socialistic ideals into Indian corporate law.

This represented a marked departure from previous phases, by which the erstwhile market-oriented light-touch regulation gave way to extensive Government regulation of companies. Several provisions were introduced in the Companies Act, 1956 to reflect this change in ideology. For instance, extensive powers were conferred upon the Government to conduct audit and investigation of companies. Moreover, even certain private companies (that were hitherto subject to limited regulation) came within the purview of the full-blown Government regulation exercised over public companies.

More importantly for our purposes, and consistent with the country's journey through years of socialism, the role of company law in India

extended beyond the mere protection of shareholders. It encompassed the protection of employees, creditors, consumers and society. For instance, employees obtained certain special rights under company law, such as preferential payment for dues in case of winding-up of a company (Companies Act, 1956, s. 529-A), and also the right to be heard in case of significant proceedings involving a company such as in a scheme of arrangement (merger, demerger or other corporate restructuring)[2] (Companies Act 1956, s. 391) or in a winding-up of the company (Companies Act, 1956, s. 443).

As far as creditors were concerned, while company law did provide them with the standard rights and remedies, other special laws conferred further corporate law rights such as the ability of the creditors to convert their loans into equity of the debtor company and, more specifically from a corporate governance standpoint, to appoint nominee directors on boards of debtor companies (e.g., State Bank of India Act, 1955, s. 35A). These rights were seemingly provided to protect the interests of the creditors.

Moreover, beginning with the 1960s, the element of 'public interest' was widely infused into company law. Building upon this, affected parties were entitled to exercise remedies in case the affairs of a company were carried out in a manner prejudicial to public interest (Companies Act, 1956, s. 397(2)), or if a scheme of arrangement was not in consonance with public interest (Companies Act, 1956, s. 394(1), proviso). For example, while according its sanction to a merger, demerger or corporate restructuring that is carried out through a scheme of arrangement, the court was required to take into consideration the effect of such a transaction on public interest. Hence, Indian company law began recognizing the interests of non-shareholder constituencies in a more sustained fashion during the 1960s with the onset of socialist ideology in the Indian legislative process. The express recognition of 'public interest' in the companies' legislation is demonstrative of its intention to re-conceptualize the notion of a company, and to extend the domain of company law from catering merely to private interests into one that specifically considers the societal impact of a company's operations.

These changes in the character of corporate law were supplemented by the enactment of related economic statutes that buttressed the socialist ideology held by the Government. Two statutes are worthy of mention,

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[2] Mergers, demergers and other forms of corporate restructuring are usually effected through a 'scheme of arrangement' that not only requires the approval of different classes of shareholders and creditors, but also the sanction of the relevant court of law (Payne 2011).

albeit merely as examples. First, the Monopolies and Restrictive Trade Practices Act, 1969 (the 'MRTP Act') was enacted to curb the concentration of economic power, for the control of monopolies and for the prohibition of monopolistic and restrictive trade practices. Second, the Foreign Exchange Regulation Act, 1973 ('FERA') imposed significant capital controls and restrictions on foreign exchange transactions that had an impact on foreign investment in India. For instance, foreign investors were allowed to invest only up to 40 per cent of the shares in Indian companies, with the remaining shareholding to be held by domestic investors. Together with the company law changes discussed above, these measures had the impact of curbing the actions of companies, keeping in mind the larger interests of the economy and society.

Interestingly, during the socialist era, the legislature was not the only arm of the state that was cognizant of the interests of non-shareholder constituencies. The judiciary too followed suit through innovation by providing an expansive public character to the company rather than accepting it as an entity consisting merely of private interests. This it did by stretching the contours of company law to fit within the constitutional jurisprudence underlying the times. The Constitution of India was amended in 1976 to include the word 'socialist' in its Preamble, which now provides that India is a 'Sovereign Socialist Secular Democratic Republic'.

One significant ruling of the Supreme Court of India is characteristic of the judicial expansion of the nature and purpose of a company under Indian corporate law (National Textile Workers 1983). It observed:

> The traditional view of a company was that it was a convenient mechanical device for carrying on trade and industry, a mere legal frame work providing a convenient institutional container for holding and using the powers of company management. … This doctrine glorified the concept of a free economic society in which State intervention in social and economic matters was kept at the lowest possible level. But gradually this doctrine was eroded by the emergence of new social values which recognised the role of the State as an active participant in the social and economic life of the citizen in order to bring about general welfare and common good of the community. … The adoption of the socialistic pattern of society as the ultimate goal of the country's economic and social policies hastened the emergence of this new concept of the corporation. … But, one thing is certain that the old nineteenth century view which regarded a company merely as a legal device adopted by shareholders for carrying on trade or business as proprietors has been discarded and a company is now looked upon as a socio-economic institution wielding economic power and influencing the life of the people.

In adopting this approach, the Supreme Court of India departed from the colonial conception of a company, which was free-market oriented, and hence embarked on a dynamic process that was in tune with the process of economic and social transformation that marked the Indian corporate sphere.

In all, during the socialist era, a combination of legislative measures and novel judicial philosophy revolutionized the nature and purpose of a company under Indian corporate law. The company's origin as a private business organization metamorphosed into one that carries a public character with broader societal overtones (Varottil 2016a).

However, by the late 1980s, the Government began a process of reconsideration of its economic policies. Given that India's foreign exchange reserves had depleted significantly, the Government was compelled to give way to its strict adherence to the socialist principles and instead had to begin the process of economic liberalization, which it did so in 1991 (Kumar 2006). This had an immense impact on corporate law, which underwent some course correction in veering back to the focus on private interests with a view to attracting greater investment, both foreign and domestic. Arguably, the interests of the other stakeholders were temporarily crowded out, and did not receive much attention for two decades.

IV. CORPORATE LAW IN THE ERA OF ECONOMIC LIBERALIZATION (1991–2013)

In 1991, the Government introduced a new economic policy that ushered in an era of liberalization in order to enhance business activity and foreign investment. For example, it reduced the requirement of industrial licensing to only a small range of industries, permitted companies to freely issue capital and opened up several sectors of the economy to foreign investment (Kumar 2006). This was a reversal of sorts compared to the restrictive policies followed during the socialist era, and was necessitated due to the prevailing economic situation. Consequently, corporate law too witnessed significant changes. The Companies Act, 1956 underwent a series of amendments. Moreover, a slew of securities legislation was introduced to promote the stock markets. Related to this, the securities regulator required companies to adopt specific measures to enhance corporate governance. As I discuss below, these measures were intended solely for the protection of shareholders and to maximize the value of their investments. The welfare of other stakeholders and the

emphasis on 'public interest' that epitomized the socialist era was considerably played down.

During the period of liberalization, several changes were introduced in the Companies Act, 1956 that enabled companies to raise and restructure capital. Sufficient flexibility was provided to companies to engage in wider types of share offerings and to buy back securities. Similarly, the MRTP Act was also amended to allow mergers and acquisitions to be carried out without any restrictions from the purview of competition or antitrust law.

The changes introduced to securities regulation were more extensive in nature. These were spearheaded by India's securities regulator, the Securities and Exchange Board of India ('SEBI'), which was established in 1992. SEBI introduced a disclosure-based regime for public offerings of securities by Indian companies. It had a strong hand in the promotion and expansion of India's capital markets in the 1990s and 2000s, as Indian companies accessed the capital markets by raising capital worth billions of dollars during the period. Simultaneously, SEBI also took shape as a strong securities regulator by not only promulgating a number of regulations governing various aspects of the securities markets, but also by enforcing those regulations utilizing various powers that were conferred upon it over time.

For the first time in India's corporate history, the lawmakers began focusing on corporate governance, initially as a measure to attract greater foreign investment. The first initiative towards enhanced corporate governance norms came from industry, and that too voluntarily. In 1998, a task force constituted by the Confederation of Indian Industry ('CII') recommended a 'Desirable Code of Corporate Governance', which a handful of leading Indian companies adopted. Thereafter, following a report submitted in 2000 by a committee under the chairmanship of Mr. Kumar Mangalam Birla, a leading industrialist, SEBI amended the terms of the listing agreement to impose essential corporate governance norms on large listed companies on a mandatory basis. These norms were further strengthened following the recommendations in 2004 by a committee established under the chairmanship of Mr. Narayana Murthy.

As Afsharipour (2017) elaborates, there was considerable ambiguity in the focus of the efforts discussed above. Their primary emphasis was on maximizing shareholder value, as shareholders were considered the essential beneficiaries of corporate governance norms. At the same time, stakeholder interests were not entirely ignored, although there was neither a clear definition nor enunciation of such interests. In that sense, shareholder value remained the touchstone, with stakeholders arguably receiving only rhetorical treatment.

In all, during the liberalization era, we see a stated preference from policymakers to signify a shift from the erstwhile socialist policies towards a more market-oriented framework with an eye towards enhancing business opportunities and foreign investment. In the process, minority shareholder protection became the *mantra*, and other stakeholders' interests received less attention, if at all.

In the meanwhile, the calls for a complete overhaul of the Companies Act, 1956 grew louder as the legislation had undergone a series of amendments over the years, and it had arguably outlived its relevance and utility. A more recent reform effort led to the enactment of the Companies Act, 2013 that marks the current corporate law landscape in India. The policy imperatives that dictated the reform process are crucial to determine the nature and purpose of a company under the current dispensation.

V. RECENT COMPANY LAW REFORM EFFORTS: THE COMPANIES ACT, 2013

In this section, I discuss some of the policy issues and tensions that were prevalent during the somewhat lengthy process of enacting the Companies Act, 2013. Several factors were at play behind the scenes for this new legislation, which enable us to understand the nature and purpose of a company. While the liberalization phase commencing 1991 attempted to break away from the socialist overtone of prevailing corporate law in India, the Companies Act, 2013 reverses the trend and reinforces the public nature of corporate law and reorients it towards socialist principles, albeit in a subtler and more nuanced way, including by introducing specific concepts and mechanisms to operationalize the renewed ideology. To that extent, the Companies Act, 2013 has been described as 'a radical experiment with corporate purpose' (Afsharipour 2017).

Since the 1990s, several efforts had been made to reform company law by way of an overhaul of the Companies Act, 1956. Although several Bills had been presented in Parliament, none fructified into legislation. The immediate origin of the Companies Act, 2013 can be attributed to an Expert Committee on Company Law established under the chairmanship of Mr. J.J. Irani. Its report suggested streamlining company law and was indeed market-friendly, but at the same time subscribed to strict norms of corporate governance (Irani Committee Report 2005). However, the norms were largely focused on shareholders, with some brief mention of the need to have regard to employee interests. Based on this report, the Companies Bill, 2008 was presented in Parliament, although the Bill did

not make any references to non-shareholder constituencies (Naniwadekar and Varottil 2016).

In the meanwhile, a major corporate scandal involving a leading information technology company, Satyam Computers, shocked corporate India. In January 2009, the chairman of the company confessed to a fraud to the magnitude of over US$ 1 billion. In terms of lawmaking, this episode triggered renewed calls for strengthening the corporate law and governance norms in India. However, when the Companies Bill, 2009 was presented in Parliament following the outbreak of the scandal, no changes were forthcoming to the proposed draft legislation compared to the previous version of the Bill.

What was to occur in the next phase of the lawmaking process defined India's move further in the direction of conferring greater protection to non-shareholder constituencies and to attribute a public character to the impact of a company's activities. The Companies Bill, 2009 was referred to the Parliamentary Standing Committee on Finance under the chairmanship of Mr. Yashwant Sinha, which issued its report after a series of consultations and hearings (Ministry of Corporate Affairs 2010). Although the Companies Bill, 2009 appeared to turn a blind eye to the fateful occurrences of scandals that rocked corporate India, the Standing Committee undid the effects of those deficiencies by recommending detailed provisions in corporate law to prevent such failures in the future. Specific among the Standing Committee's recommendations were heightened standards of corporate governance and measures to rein in company managements and impose higher standards on gatekeepers such as independent directors and auditors. But, it is the other set of measures introduced by the Standing Committee that is of immense significance as it redefined the nature and purpose of the company in the Indian context. While the Companies Bill, 2009 was shareholder-oriented, in that directors owed duties to carry on the business of the company 'for the benefit of its members as a whole' (clause 147(2)), the Standing Committee insisted on a broader stakeholder approach to corporate law, insisting that directors have a duty 'to promote the objects of the company in the best interests of its employees, the community and the environment as well'. (Ministry of Corporate Affairs 2010). Most significantly, a provision relating to corporate social responsibility ('CSR') was introduced requiring a mandatory spending by large companies towards social causes. This required companies to have a corporate social responsibility policy including spending on CSR in the form of 'at least 2 per cent of its average net profits during the three immediately preceding financial years' (Ministry of Corporate Affairs 2010). In this context, in broadening the duties of directors of a company, the Standing Committee noted:

> The Committee welcome the proposed changes with regard to the duties of a director to promote the objects of the company in the best interests of its employees, the community and the environment as well, particularly in the backdrop of Corporate Social Responsibility, which is proposed to be included in this statute … .

Following the Standing Committee Report, the Government introduced the Companies Bill, 2011 in Parliament, which naturally contained significant changes from the Companies Bill, 2009. The 2011 Bill was referred back to the Standing Committee for review of the revised provisions, particularly because it contained significant changes from the previous version. The Standing Committee issued another report (Ministry of Corporate Affairs 2012), following which the Companies Act, 2013 was passed by both Houses of Parliament and received the assent of the President of India on 31 August 2013. This legislation has been brought into effect in stages.

In this context, it would be useful to consider some of the policy issues underlying the enactment of the Companies Act, 2013 as it relates to corporate purpose. While the Companies Bill, 2009 (and its identical predecessor of 2008) was based on the Irani Committee recommendations, which were market-oriented in nature and focused on attracting investments by protecting shareholder interests, the result of its review by the Standing Committee transformed it into a document with radically different philosophical overtones that emphasized stricter controls through regulation and also emphasized the social responsibility of corporations. These philosophical pressures are quite evident. It is clear that the Irani Committee was concerned with attracting greater investment and providing a simple and clear regime for businesses. However, the Standing Committee approached the legislative process from a completely different perspective. Significantly, it was operating in the shadow of a corporate scandal that evoked outrage within the country, particularly against the corporate sector and the business community (Varottil 2016a). That might perhaps explain the Standing Committee's insistence on a stakeholder approach that encompasses constituencies such as the employees, customers and the environment as beneficiaries within the corporate law sphere rather than merely shareholders. In the wake of these scandals, a lukewarm response by the political class would be met with disdain. It may also be seen as a counteraction by the political class to curb the influence of the business sector and to impose adequate checks and balances through corporate law (Varottil 2016a). It

is a confluence of these factors that led to a compromise that is evident in the Companies Act, 2013 and a number of its specific provisions.

As this section indicates, the recent reforms have emphasized considerably the protection of stakeholder interests in corporate law. Moreover, the CSR regime has effectively infused a public character to companies in imposing obligations on them to act beyond shareholder interests, and to also take into account the interests of other stakeholders.

The historical survey of the evolution of corporate law along the private-public or market-state regulation lines reveals some interesting findings. For the most part (1850–1960), corporate law in India had been largely shareholder-centric with almost no focus on stakeholders or public interest. However, during the peak of the socialist era (1960–91), the tenor of corporate law underwent significant change (both legislatively and judicially) by which the public nature of a company became prominent in the discourse. Matters swung back temporarily towards a shareholder focus in the 1990s and 2000s because of economic liberalization and the need to attract more capital, particularly from foreign investors. Finally, this temporary phase appears to have come to an end when the pendulum has swung back again towards the public character of a company due to the express provisions of the Companies Act, 2013. In order to appreciate the historical origins and oscillations regarding corporate purpose, it would be useful to consider how the current legislation deals with stakeholder interests, which the next section seeks to achieve.

VI. PROTECTION OF STAKEHOLDER INTERESTS: REASONS AND COMPARISON

Given that Indian corporate law initially evolved through the process of transplantation from English law, it would be interesting to examine how the law has evolved following India's decolonization when it comes to the nature and purpose of a company. Moreover, it would also help to compare Indian corporate law with developments in parallel English legislation on the same count. Such comparisons are instructive of the fact that current Indian corporate law has not only deviated substantially from its colonial origins, but it has also adopted a different trajectory compared to England even though the two countries share a common law heritage.

As we have seen, the question of whether companies should be run for the benefit of their shareholders or whether the interests of other stakeholders must be taken into account is a vexing one. The colonial law

in India was unequivocal in its zeal to protect shareholders so as to enable companies to attract capital. Corporate law did not play any role at all in taking cognizance of the interests of non-shareholder constituencies. This position continued immediately following decolonization, but the change in philosophy began taking shape in the 1960s with amendments to the Companies Act, 1956, which was also consistent with the escalation of the socialistic sentiment of the period. The legal position has evolved substantially in the post-colonial era such that corporate law's approach towards viewing the company as a private matter has given way to an approach that considers the company as carrying wider societal ramifications and affecting public interest. This vision of the corporate entity not only contrasts with the colonial origins of Indian corporate law, but stands at considerable variance with the English position, which continues to be staunchly shareholder-oriented.

If Indian corporate law was already stakeholder-oriented during the socialist era, the recent reforms culminating in the Companies Act, 2013 buttress that further in several ways. Here, two such reforms are indicative of this move, viz. (i) expansion of directors' duties, and (ii) corporate social responsibility.

Hitherto, directors of Indian companies had negligible guidance under company law as regards their duties and liabilities. The erstwhile Companies Act, 1956 did not explicitly stipulate directors' duties, which made it necessary to fall back on common law principles (to be articulated by courts while delivering specific decisions). The statutory uncertainty was compounded by the absence of significant cases of director duties and liabilities before Indian courts. This somewhat unsatisfactory situation has been mended in the Companies Act, 2013, which is explicit about directors' duties (somewhat similar to the codification of directors' duties under section 172 of the UK Companies Act of 2006). The new provisions not only provide greater certainty to directors regarding their conduct, but also enable the beneficiaries as well as courts and regulators to judge the discharge of directors' duties more objectively.

More importantly for our present purpose, the Companies Act, 2013 extends the stakeholder principle further while codifying directors' duties. It provides:

> A director of a company shall act in good faith in order to promote the objects of the company for the benefit of its members as a whole, and in the best

> interests of the company, its employees, the shareholders, the community and for the protection of environment.[3]

Even if there was a doubt under previous legislation as to the extent to which stakeholder interests are to be considered by directors of a company, it has been put to rest in the new legislation. In other words, shareholders are not the only constituency that deserves the attention of directors; other constituencies such as employees and even the community and the environment are to be considered by the directors.

Furthermore, independent directors too are specifically tasked with catering to the interests of stakeholders. In defining the role of independent directors, Schedule IV of the Companies Act, 2013 that sets out a code of conduct for such directors stipulates that they are to 'safeguard the interests of all stakeholders, particularly the minority shareholders' and to 'balance the conflicting interest of the stakeholders'. In that sense, minority shareholders are treated as one among several stakeholders without receiving any preferential treatment whatsoever.

While the stakeholder approach was considered during the latest English company law reform process, matters were resolved rather differently. There, the Company Law Review came up with proposals to cater to stakeholder interests (The Company Law Review Steering Group 1999). Essentially, two approaches were considered: (i) the pluralist approach, which states that 'company law should be modified to include other objectives so that a company is required to serve a wider range of interests, not subordinate to, or as a means of achieving, shareholder value … , but as valid in their own right', which represents an expansive conception of stakeholder interest; and (ii) the enlightened shareholder value ('ESV') approach, which takes the position that the ultimate objective of company law to generate maximum shareholder value is also the best means of securing protection of all interests and thereby overall prosperity and welfare. In other words, the latter approach conceives of a merger of interests of stakeholders and shareholders by adopting the position that if the company acts to preserve stakeholder interests, then that would necessarily bring about enhancement of shareholder value. However, after some extensive debate, it is the ESV model that has received statutory recognition in the UK. This appears to be a hybrid approach that is primarily for the benefit of shareholders, but also obliquely takes into account the interests of other stakeholders. Notwithstanding this compromise, it is clear that in case of conflict between

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[3] Companies Act, 2013, No. 18, § 166(2) Acts of Parliament, 2013 (India).

various interests, the directors must prioritize shareholders' interests, which is the paramount goal (Naniwadekar and Varottil 2016).

On the other hand, in the context of the aforesaid dichotomy, the Companies Act, 2013 in India has preferred to adopt the pluralist approach by providing recognition to both stakeholders and shareholders, without necessarily indicating a preference to either. This approach remains wedded to the stakeholder model of corporate law. Despite the superficial similarity between the English and Indian legal provisions on directors' duties, there is a vital distinction in that shareholders continue to occupy a pivotal position in England, whereas in India they are only one among a number of constituencies that command the attention of directors. This indicates that corporate law in India has diverged considerably not only from its colonial origins, but also from contemporary English law. While English law continues to display a preference for shareholder value, India has underplayed it in the larger interests of all stakeholders. India's post-independence slant in the direction of socialism might explain this phenomenon.

Related to this is the newly introduced requirement of CSR, which has gained considerable traction. The concept of social responsibility of corporations is not novel, and has been part of the indigenous thinking during the colonial era (Mayer 2013). After much debate, CSR found its place in the Companies Act, 2013 whereby every company of a certain size is to announce a CSR policy. More importantly, India is one of the earliest countries to require large companies to spend at least 2 per cent of their average net profits made during the three immediately preceding financial years in pursuance of its CSR policy towards specified activities (Afsharipour and Rana, 2014).[4] During the legislative process, there was an intense debate as to whether the spending requirements must be made mandatory, but in the end due to a compromise the position resulted in a 'comply-or-explain' approach, although the wording of the statutory provision largely operates as a mandate. These developments are a far cry from the position that prevailed during the colonial period, which was a single-minded focus on shareholder interests. They also take India in a different direction compared to the largely shareholder-oriented focus that continues to operate in contemporary UK. While the corporation has acquired public overtones in India, which have only increased over time,

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[4] For a more detailed analysis of the CSR regime in India, see Afsharipour and Rana (2014), Van Zile (2012), Gopalan and Kamalnath (2015), and Dharmapala and Khanna (2016).

the broader stakeholder interest is subservient to shareholder value enhancement in the UK context.

VII. CONCLUSION

Despite considerable advancements in the corporate law discourse, substantial disagreements continue regarding the nature and purpose of a company. In particular, there are differing viewpoints on whether companies and their boards and managements ought to be shareholder-centric or more pluralistic in their approach (considering the interests of all stakeholders). While the debate continues, this chapter has focused on seeking to understand the historical evolution of Indian corporate law over more than 160 years in order to precisely identify how the law has sought to address the dichotomy between the primacy of shareholders and other stakeholders.

As this chapter finds, Indian corporate law has not been consistent in its approach in addressing the corporate purpose question. For a majority of the period, i.e., from 1850 to the 1960s, India simply adopted the English approach, which was largely shareholder-centric. It was only the socialist wave of the 1960s that enabled a relook at the nature and purpose of a company, resulting in divergence from the English origins. India returned for a couple of decades starting 1991 to the shareholder-centric model, but this time dictated by its own economic reason for enabling Indian companies to raise capital. Since 2013, however, the stakeholder model has demonstrated a strong resurgence and is now deeply entrenched in Indian corporate law.

At one level, it is hard to glean any consistent pattern in the approach. However, it is clear that the slant of corporate law towards a particular purpose has largely been driven by the economic and political imperatives of the time. In that sense, the conceptual questions of law have been intrinsically connected with the political economy, from which it draws its inspiration. While the strong stakeholder model of corporate law makes India somewhat of a pioneer among jurisdictions, if history is any lesson, it is not clear how long this tendency will last. However, India's historical experience may provide some guidance to its lawmakers as they implement (and possibly gradually adapt corporate law). It may also offer some lessons more broadly in developing the discourse regarding the corporate purpose.

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15. Japanese corporate law and corporate governance in historical perspective

Bruce Aronson

1. INTRODUCTION

A historical perspective is particularly valuable for the study of corporate law and corporate governance in Japan. In the field of business organizations and corporate governance there is broad familiarity with a stylized postwar model of the 'J-Firm' (Aoki 1990), with its emphasis on features of an internally focused system such as lifetime employment, main banks and cross-shareholding. This model is exaggerated in the popular image of 'Japan, Inc.,' which sees a culturally based system dominated by informal relationships within and among Japanese businesses, and also with the state, and in which formal law does not matter.

A historical perspective is one of the three research methodologies first used by legal scholars to refute the image of a Japan where people have a cultural disposition to avoid disputes (Haley 1978). With respect to the postwar model of the J-Firm, even a cursory historical examination reveals that prewar businesses in Japan operated under very different circumstances and structures during different periods. The development of each of the various elements that eventually coalesced around 1960 to form our familiar image of Japan's postwar model can be traced historically. This model, however was a stylized stereotype that was never fully realized by most Japanese companies. In addition, its various elements continued to evolve so that most Japanese companies look substantially different today.

This chapter's broad, historical overview of Japanese corporate law and governance from 1868 to the present indicates a nearly opposite scenario from that of a rigid, culturally determined Japan where law is unimportant. It instead emphasizes nearly constant, if gradual, change over time, significant experimentation with corporate law to meet businesses' needs, flexibility and choice rather than rigidity, and a practical effort to adapt over time to changing political, economic and social circumstances.

More specifically, there were two great waves of transformation under the influence of foreign law: the initial modernization drive during the

Meiji period (1868–1912) where the importation of European, primarily German, law led to Japan's first Commercial Code in 1899, and postwar democratization under the U.S.-led occupation following the Second World War when American legal concepts exerted a strong influence on many aspects of Japanese law, including corporate law. In both cases, the initial import of foreign law was followed by decades of gradual adaptation and implementation to create a 'Japanese' legal system and practice.

The demarcation of relevant historical periods might vary, depending on the purpose of the inquiry. For example, a focus on corporate finance (more specifically, on the level of cooperation with the state and the ownership structure of firms) could result in three periods: 1868–1927 (capital market-based economic system); 1927–80 (bank-based, state controlled economic system); and 1980–present (market-based economic system) (Ozkan 2011). On the other hand, Baum and Takahashi (2005) find seven economic periods and four combined (politics, economics and law) periods: 1868–99; 1900–45; 1946–80; and 1980–present.

This chapter follows the ongoing academic trend of placing corporate law in the context of a broader discussion of corporate governance, i.e., including 'interact[ion] with non-legal processes and institutions' (Gilson 2016). This approach facilitates capturing some of the wider trends in share ownership and finance, corporate control and monitoring, and enforcement/practice of corporate law. The first, German-inspired wave of change and adaptation (1868–1945) is subdivided into adoption of the Commercial Code (1868–99), growth of the *zaibatsu* and depression (1900–31) and wartime controls (1932–45). The second wave of American-influenced change and adaptation (1945–2008) is subdivided into commercial law reform under the occupation (1945–52), gradual reform and adaptation (1952–89), and post-bubble deregulation and reform (1990–2008). I conclude by describing a possible new post-financial crisis era characterized by a multipolar model focused on growth and soft law (2008–present).

2. THE FIRST WAVE: ERA OF GERMAN INFLUENCE (1868–1945)

Origins in the Meiji Era (1868–1912)

Japan's era of rapid modernization during the Meiji period (1868–1912), following a forced opening by the West, represents a singular achievement in law and development that has been cited as a good reason to

study Japanese law (Ginsburg 2010). Unlike other Asian countries, Japan retained its independence and eventually competed with the Western powers to develop its own empire in Asia. One important task for Japan was to develop its own legal system, on par with that of Western powers, with corporate and commercial law playing a prominent role. Although the Japanese studied many foreign systems, for this task it turned primarily to Germany, as that country was another later modernizer (Japan, Germany and Italy having all unified around 1870), and had already achieved substantial success. The adaptation of the German model was important well beyond corporate law, as it justified a significantly larger state role than, for example, the English libertarian model (Baum and Takahashi 2005: 338).

Adoption of the Commercial Code (1868–99)

Development in Meiji Japan required modern businesses, which raised capital and operated beyond the boundaries of the family-dominated merchant houses that exemplified the prior medieval Tokugawa period. Experimentation began almost immediately with efforts to create new banking entities in the 1870s. Initial efforts to force investors into banking joint ventures with outsiders were unsuccessful, but the third iteration of joint-stock banking companies, focusing often on one family, succeeded. The owners were often not prominent merchant families, but rather former samurai who received government bonds in *lieu* of their former feudal stipends and had resources to invest. As merchants had the lowest status in feudal Japanese society, the participation of samurai aided the view that the bank owners were acting for the greater public good rather than solely for personal gain (with acting in the public good also being a premise of German corporate law) (Baum and Takahashi 2005: 348–9).

In terms of statutes, Japan needed a corporate law that would facilitate the rise of modern businesses, thereby contributing to Japan's economic growth and national (military) strength and independence, and a more general commercial law to aid in removing unequal treaties with Western powers. A draft of a corporate law (although based on English law) appeared as early as 1875. The government requested Hermann Roesler, a German professor and adviser, to draft a law in 1884. A partial corporate law was enacted in 1893 and the full Commercial Code in 1899.

The Commercial Code of 1899 (unlike its 1893 predecessor) gave priority to local trade custom over general provisions of the Civil Code (for matters not directly covered in the Commercial Code) and utilized a

registration system for corporations as opposed to a licensing system (under which government officials would have scrutinized and approved those applying for limited liability) (Baum and Takahashi 2005: 360–61). The three business entities under the Commercial Code were the stock corporation, general partnership and limited partnership. The corporation, in turn, was governed by three institutions: an all-powerful general shareholder meeting; directors (any one of whom could legally bind the corporation); and *kansayaku* (in English, corporate auditor and other translations) who were tasked to supervise or audit for both illegality and for activities that were not in the best interests of shareholders.

The Commercial Code did not include Germany's GmbH organizational form for small businesses, which some would call the crown jewel of German corporate law. However, the key point may be that Japanese corporate law was applied more liberally and flexibly than in Germany to accommodate business interests, as the claim is made that, in fact, Japanese business developed successfully *despite* the use of German law (Hannah and Kasuya 2015: 3).

Growth of *Zaibatsu* and Depression (1900–31)

The *zaibatsu*, or family-controlled conglomerates, evolved to deal with a common problem: how could traditional family businesses retain control while expanding rapidly through the use of public capital? The solution was to utilize a pyramidal structure in which layers of listed subsidiaries successively leveraged assets by setting up their own subsidiaries. Despite an image of *zaibatsu* being uniform and distinctively 'Japanese,' there were both considerable variety among Japanese businesses and also similarities between the *zaibatsu* and the growth of family dominated enterprises in other countries (Morck and Nakamura 2007: 383). Today this technique is often known as tunneling, and an often-cited example of its use today is by Korean *chaebol* (which is the Korean pronunciation of the two Chinese characters used in the Japanese word *zaibatsu*).

There was significant variation among Japanese businesses. Most business assets were not held by *zaibatsu*, and companies often relied on public markets to obtain capital. In fact, Japan in the 1920s is often referred to as 'the era of Taisho democracy,' in which companies often relied on public markets for financing and pursued shareholder-friendly policies with regard to profitability and stable dividends. Even among the *zaibatsu*, no single pattern emerged and there is no clear definition of the term (Morck and Nakamura 2007: 376). For example, some utilized public capital, while others (particular those who owned mining operations) were able to fund themselves internally. They were formed at

different times and sometimes assumed different organizational forms (Shimizu 2016), although tax policies strongly encouraged the use of holding companies rather than family partnerships. The *zaibatsu* were typically family-owned, but even that was not true for all of them (e.g. Nissan).

The *zaibatsu* were significant, however, in political terms. Some of them were buyers of government-owned businesses during a mass privatization in the 1880s. The *zaibatsu* generally worked closely with the government and were most responsive to increasing government-related business opportunities as the military gradually assumed greater importance. They diversified rapidly following the economic boom in World War I (Baum and Takahashi 2005: 368–9). Limited liability also aided their rapid expansion during and after the war.

Managerial control of the *zaibatsu* families also varied. They generally hired professional managers for their subsidiaries and gave them significant discretion. In some cases, the controlling entity was relatively hands-off and acted more like a coordinating head office (Baum and Takahashi 2005: 371). However, from a corporate governance perspective, family-controlled holding companies may have also engaged in effective monitoring of their subsidiaries (Okazaki 2001). In many cases a combination of family-related executives and professional managers actually operated the subsidiary companies.

Wartime Controls (1932–45)

This period saw a gradual transformation from a relatively open economy and political system to a state-controlled wartime economy and political system. After a decade of depression a crisis management programme was enacted in 1931. Increased military control led to concentration on heavy industry and additional government regulation.

Following a decade of economic failure, there were strong criticisms of capitalism and democratic politics from both the left and right. Shareholders and management were accused of pursuing their own selfish interests and, echoing criticism of companies today, engaging in short-termism. This was at least partly attributed to a failure of corporate governance—an argument that corrupt and inept directors were in charge of companies due to a combination of family and political connections—which the public generally accepted and therefore supported the concept of the military harnessing this economic power for national purposes (Morck and Nakamura 2007: 420). Under this programme banks were nationalized, the economy gradually became subject to a governmental

central planning system and the role of shareholders was supplanted by the state.

Pressure on the *zaibatsu* resulted in a '*zaibatsu* conversion,' in which they became ostensibly more public-oriented: less overt family management; the founding of charitable trusts; greater openness to public shareholders; and, most importantly, alliances with the military and bureaucracy (partly sought, since the military and state were the focus of economic activity and partly resisted due to the loss of actual control) (Baum and Takahashi 2005: 372). While the *zaibatsu* family members remained as *de jure* owners, the state and employees came to dominate Japanese companies.

A revision of the Commercial Code in 1938 nevertheless tried to protect general shareholders from arbitrary actions by directors through means such as additional public disclosure and greater authority for the general shareholders meeting. At the same time a new corporate form was introduced, the *yugen kaisha*, which was a kind of limited liability company for small business similar to the German GmbH. The number of these companies grew and they became relatively popular (Shimizu 2014), but all major companies in Japan were still stock companies (*kabushiki kaisha*). Stock companies were less regulated than their German counterparts and could be owned and operated as private companies (Hannah and Kasuya 2015). The Commercial Code revision of 1938, like an earlier one in 1911, tried to adapt to the rise of large corporations and prevent fraud; they also represented a delayed response to changes in German corporate law (Baum and Takahashi 2005: 373).

3. THE SECOND WAVE: THE ERA OF AMERICAN INFLUENCE (1945–2008)

Corporate Law reform in 1950 under the U.S. Occupation (1945–52)

A basic pillar of occupation policy to promote democracy in Japan was economic deconcentration—breakup of the *zaibatsu* which had supported militarism and dispersal of the *zaibatsu* shares from private hands to individual shareholders among employees and the general public. It was thought that the creation of a strong, American-style public capital market, as opposed to the family-controlled *zaibatsu*, would aid both economic growth and democracy. At the same time, banks were prevented from underwriting securities and their ownership of business corporations was limited to 5 per cent. Economic deconcentration was

launched under the 1947 Antimonopoly Law, and a new Securities and Exchange Law was enacted in 1948.

In order to reinforce and sustain a broader system of shareholding, the last major legal revision of the occupation was in corporate law (the Commercial Code revision of 1950). Unlike the securities law, which was essentially imported whole from the U.S., corporate law reform necessarily utilized American concepts to modify the existing German-based Commercial Code. The 1950 revision provided greater flexibility for corporations in stock issuance and other financial measures, greater authority for the board of directors and management (since stockholders would now be widely dispersed and could not directly manage the corporation), and new rights for shareholders (providing them with sufficient means to monitor management and confidence to remain as investors in public corporations) (see Table 15.1).

Table 15.1 Summary of major corporate law areas in Commercial Code Reform of 1950

Area of Reform	Premise	Result
Rearrangement of Corporate Powers	With dispersed public shareholders, need professional management	1. Decision-making authority moved from shareholders to Board of Directors 2. Monitoring of Board and management moved from corporate auditors to shareholders
New Methods of Corporate Financing	With end of *zaibatsu*, need public investors on the open market and greater efficiency/flexibility	1. Flexibility in stock issuance and corporate finance 2. New Board authority for stock consideration, dividends, etc.
Strengthening Shareholders' Rights	Need rights for individual investors to monitor the Board and management and keep them as investors	1. Voting rights 2. Direct rights (inspection of books and records, detailed financial statements, directors' fiduciary duties, etc.) 3. Property rights (free transferability of shares)

Source: compiled from Blakemore and Yazawa 1953.

The 1950 Commercial Code reform led to contentious debate on a number of basic issues, beginning with its very necessity. One view, by Lester Salwin, an occupation lawyer from the Economic Section of SCAP (Supreme Commander of the Allied Powers) who headed up the effort to revise the Commercial Code, was that corporate law reform under the occupation was necessary, collaborative, and successful (Salwin 1962–63). Under this view, corporate law reform was necessary to support deconcentration and 'corporate democracy', and also to correct prewar abuses. It was collaborative, like occupation policy in general, in that German-based corporate law had already evolved into 'Japanese' law, the relevant concepts were not that different between Japanese law and American law, and SCAP played only an advisory role with the Japanese side actually drafting the reforms. Corporate law reform was successful since it contributed to preventing any revival of the *zaibatsu* and also to slow, but steady democratic reform.

An opposing view was presented by another American occupation lawyer, Thomas L. Blakemore, and a prominent Japanese professor of corporate law, Makoto Yazawa (Blakemore and Yazawa 1953). They argued that corporate law reform under the occupation was unnecessary, unilaterally imposed by the occupation authorities, and unsuccessful. It was unnecessary, since there was no need for the occupation to reform normal business law as part of deconcentration and democratization, and particularly not by grafting American legal concepts onto a continental law system. It was unilaterally imposed since the Japanese side objected strongly to the new shareholder rights, fearing abuse by radical labour groups and *sokaiya* (racketeer shareholders) to harass management. It would be unsuccessful since the Japanese would undo these corporate law reforms once the occupation ended.

Both sides focused on shareholder rights as being the most controversial of the corporate law reforms. However, as noted in Table 15.1 above, two of the three major areas of reform are 'pro-management' rather than 'pro-shareholder' since they act to increase the authority of the board of directors and management to manage the financial and business affairs of the corporation. As noted below, this division of reform arguably set a postwar pattern. Salwin's broad purpose for corporate law reform also foreshadowed the widening of future discussion from 'corporate law' to 'corporate governance'.

Both of the above views on Commercial Code reform had poor predictive powers. The period of ownership by individual shareholders did not last; within a decade there was substantial reconcentration of ownership as shares of public corporations migrated from individuals to corporations in a new corporate cross-shareholding system (which played

a substantial role in the postwar emergence of *keiretsu* groups) (Repeta 1984). On the other hand, the Japanese did not reject corporate law reform as unilaterally imposed or as 'un-Japanese' when they had the chance following the end of the U.S. occupation in 1952; only three discrete provisions were amended during the next two decades to return to their pre-1950 form (West 2000–01: 558).

Thus Japan neither returned to anything like its prewar system nor did it adopt an American system. New, American-influenced code provisions tracked American law—in particular, Illinois corporate law, which was familiar to the occupation lawyers and also provided the basis for the American Revised Model Business Corporation Act—but subsequent developments in U.S. and Japanese corporate law diverged (West 2000–01). Over time adaptation in Japan to formal legal change gradually led to a new Japanese system that may have been something between Japan's prewar system and the American system—a relatively concentrated ownership system (broadly similar to Germany) but without individual (or family) controlling shareholders.

Gradual Reform and Adaptation (1952–89)

There were a number of additional amendments to corporate law provisions of the Commercial Code during this period (five post-occupation amendments), in an attempt to implement the new emphases of the 1950 revision and reconcile the American-inspired reform with Japanese practices.

One set of amendments addressed the American-inspired rearrangement of corporate powers, in which the board of directors gained power at the expense of *kansayaku* and shareholders. Attempts to ensure that the board of directors fully performed its functions included an 1981 amendment that required the board take action on significant corporate matters to avoid 'one-man rule' by powerful company presidents (Kanzaki and Tatsuta 1983).

Japanese companies resisted the idea of outside directors, and a series of amendments to the Commercial Code (beginning in 1974) gradually strengthened the role of *kansayaku*. They were once again charged with preventing illegality, but were not clearly given legal authority to monitor whether actions were in the best interest of the corporation. Although they were given powers that directors did not have, such as inspection rights and the right to request a court injunction for illegal acts, they could not vote in board meetings or hire and fire directors (as can the supervisory board in Germany) (Aronson, Kozuka and Nottage 2016: 197). It is argued that the corporate auditors thus faced an 'identity crisis'

as it was increasingly hoped that *kansayaku* could act as substitutes for independent directors despite a lack of corresponding authority (Matsunaka 2012). However, international institutional investors generally did not accept the newly strengthened *kansayaku* as being functionally equivalent to independent directors (Asian Corporate Governance Association 2013).

A second set of amendments dealt with the new shareholder rights granted under the 1950 revision. As feared by business interests, unscrupulous *sokaiya* emerged to force payments from company management by threatening to disrupt shareholder meetings or publicly disclose embarrassing information about management. Several Commercial Code amendments sought to restrict their activities. However, such changes initially seemed to have little effect on actual practices related to general shareholder meetings.

This was also the period that witnessed Japan's 'economic miracle' and, in academia, the famous description of a new, stylized 'J-Firm' for Japanese companies that did not follow the standard contractual model of the firm in Western (or at least Anglo-American) literature on the theory of the firm. Japanese economists focused particularly on the example of Toyota, with its 'just in time' and 'lean' manufacturing (Aoki 1990).

Key features of the stylized J-Firm included providing benefits to permanent employees ('lifetime' employment); insider-dominated boards; close cooperation among businesses, including membership in a *keiretsu*; and large shareholdings by main banks and other group companies. In terms of monitoring management, this account paid little attention to the formal legal duties under corporate law of directors and company auditors, and instead emphasized the practical monitoring role of main banks, who were the major supplier of funds to the firm and in position to intervene if the firm fell into distress (contingent governance), as well as the monitoring roles of affiliated business partners and product markets.

This system was also supported by a government that backed the banking industry and would rescue individual banks if necessary (the 'convoy' system), and stability (and support) from the political ruling party and government bureaucracies (Aoki 2007). The role of the government prompted some business school scholars to speculate in a 'varieties of capitalism' literature whether the new Japanese form of 'government-coordinated economy' would eventually transform into a 'liberal market economy' (Deeg and Jackson 2007).

Comparative corporate law scholars generally accepted the view attributed to Aoki that Japan needed to develop informal substitutes for long-term contracts and other legal mechanisms due to some combination

of weak law and strong cultural values (Gilson and Roe 1993). In this popular account of Japanese corporate governance, law was 'conspicuous by its absence' (Milhaupt 1996: 4).

There is academic debate about whether this stylized postwar system described by Aoki widely existed in Japan, or whether it was limited to certain large manufacturers for a particular period of time. Various elements of this model were criticized. Due to inconsistencies in the definition and application of concepts like *keiretsu*, Miwa and Ramseyer (2006) famously claimed that the entire 'system' was a myth. The purported role of main banks was also questioned, as they were thought to act primarily to monitor their lending (fixed claims) rather than to monitor management on behalf of shareholders (Aronson 2003: 16–17). A more widespread criticism is that the postwar system was never more than an idealized stereotype whose elements were already fading by the time it became well known in the 1980s (Milhaupt 2002). Although Aoki himself duly noted changes in Japan's organizational form over time (Aoki 2007), his original version of Japanese business organization arguably became highly popular in a rigid and exaggerated form.

How did the various elements of this J-Firm 'system' emerge? Some institutions survived, even if modified, from the prior period of wartime controls (even if many corporate aspects prevalent during that period represented a significant departure from earlier practices). Both the occupation authorities and the postwar Japanese government continued to rely on organizations and techniques from the war to promote the new message of democracy (Dower 1999). The importance of managers over shareholders continued despite the 1950 changes in the Commercial Code, as *zaibatsu* family members and other shareholders had already been sidelined during the wartime controls period in favour of professional managers who had been operating Japanese corporations with little monitoring (so long as government production quotas were met).

Other elements were new. The postwar narrative of harmonious labour relations for the sake of economic development was clearly not true during the 1950s, when labour strife was widespread. Debate remains among historians today as to whether labour peace achieved around the time of Prime Minister Ikeda's 'income-doubling' policy of the early 1960s represented a grand compromise between management and labour or a management crushing of labour strikes and resistance (Gordon 1993). Institutions such as the *keiretsu* arose in response to the threat of hostile takeovers during the occupation years and opportunities presented by the sale of company shares by individuals, i.e. as a result of adaptation to changes in political, economic, social and legal conditions.

In short, there was no preconceived, grand design for Japan's success; we tended to find one only in retrospect. Japan's high economic growth rate was broadly equated with economic success (Hein 1993). This led to a simplified view of the existence of a fully planned, carefully executed, and consistent economic policy (and arrangements for business organizations) in Japan. This view ignored Japan's complexities, inconsistencies, and inconclusive, ongoing debates throughout the period of its perceived postwar success. During the early postwar period bureaucrats at MITI (the then Ministry of International Trade and Industry) were experimenting with industrial policy and administrative guidance as they went along (Johnson 1982).

Deregulation and Reform (1990–2008)

The bursting of Japan's economic bubble in the early 1990s, together with U.S. pressure in trade negotiations (the Structural Impediments Initiative, or SII) led to further reform, including a new emphasis on economic restructuring and deregulation in an effort to help boost the economy. In a broad sense, reform measures initiated from the mid-1990s sought to shift the emphasis from informal bureaucratic coordination to greater private market initiatives based on legal rules and their interpretation (Aronson, Kozuka and Nottage 2016: 103). Corporate governance was one area of reform, as it was thought that greater shareholder orientation by corporate management would result in an increase in investor returns and stock market attractiveness. The ultimate result would be a shift from a manufacturing-based, export-oriented economic model to a new service-oriented, postindustrial economic model for Japan (Aronson 2013: 167).

This round of reform efforts produced numerous (nine) corporate law amendments in the Commercial Code between 1993 and 2002 (Nottage, Wolff and Anderson 2008: 13–20; West 2001: 587), including, for example, the reintroduction of holding companies which had been banned during the occupation (as too reminiscent of the *zaibatsu*), but which were now deemed an aid to restructuring large companies and streamlining management. This example illustrates a continuation of the pattern established in the Commercial Code revision of 1950: roughly two-thirds of the reforms promoted management flexibility and one-third balanced this with shareholder-friendly provisions (Milhaupt 2006; Shishido 2007). These amendments culminated in the enactment of a new Companies Act in 2005, which generally modernized Japan's corporate law and further codified a number of recent reforms. The Companies Act

clearly distinguished between public and private companies, and provided private companies with a flexible menu of organizational options (Hashimoto, Natori and Roebuck 2007).

The most controversial issue during this period was whether it should be mandatory for listed Japanese companies to have outside/independent directors. International institutional investors strongly advocated for such a requirement to improve the monitoring of management and to protect shareholder interests. Japan continued to look at the then successful U.S. model as inspiration for reform, but found it difficult to reconcile mandatory provisions (e.g. in the Sarbanes-Oxley Act) with traditional Japanese practices (Aronson 2012). Business organizations in Japan successfully opposed any legal requirement for outside directors. Their position was buttressed by a popular comparison in Japan during the 2000s between the marked business success of Toyota, a champion of traditional Japanese governance, and continuing problems at Sony, an advocate of 'American-style' governance (Aronson 2012: 124).

Instead, a 2002 amendment to the Commercial Code introduced a choice of corporate forms for Japanese public corporations (Gilson and Milhaupt 2005). The traditional Japanese dual board system (now called a company with auditors) had featured a board of directors and a separate board of *kansayaku* (both elected by shareholders). A new optional alternative allowed Japanese companies to replace the traditional, German-inspired representative director and *kansayaku* positions with an American-inspired alternative: a representative executive officer and three board committees (audit, compensation, and nomination committees), with a majority of outside directors required for each committee. However, only some 2 per cent of listed Japanese companies gave up their traditional company with auditors' structure and adopted this new company with committees system (Tokyo Stock Exchange 2015b).

In addition to corporate law, securities law was also amended and renamed in 2006 as the Financial Instruments and Exchange Act. It strengthened information disclosure and reporting requirements, introduced quarterly reporting, and arguably helped position the securities regulators to exert a stronger influence over the corporate governance of Japanese companies.

Apart from corporate and securities law reform, the elements that supported the model of the J-Firm, such as cross-shareholding, significantly weakened during this period (Miyajima and Kuroki 2007). Commercial bank shareholding of Japanese listed companies declined from 15.7 per cent of the market in 1990 to 4.7 per cent in 2007 (and later to 3.7 per cent in 2015) (Tokyo Stock Exchange 2015a). It was largely replaced by a rise in foreign share ownership, from 4.7 per cent in 1990

to 27.4 per cent in 2007 (and later to 29.8 per cent in 2015). Share ownership by business corporations (i.e. cross-shareholding by non-financial firms) declined somewhat, but remained substantial at 21.4 per cent in 2007. With respect to another important element of the J-Firm model, 'lifetime employment' has remained, but the number and significance of core employees have shrunk as they have gradually been replaced by non-regular employees (Wolff 2008).

Shareholder derivative suits, which lay essentially dormant for over 40 years, began to increase as a result of losses due to the bursting of the bubble economy and a Commercial Code revision in 1993 that lowered filing fees (West 2001). A landmark case in 2000 involving rogue trading in New York at Daiwa Bank found that the board is obligated to establish a system of internal controls as part of its fiduciary duty of oversight (Aronson 2003); this duty was later incorporated into provisions of the new corporate and securities acts. Shareholder derivative suits continued to increase and have assumed a substantial role in Japanese corporate governance (Nakahigashi and Puchniak 2012). More generally, lawsuits and resulting court decisions have assumed increasing importance, as Supreme Court precedents came to cover many significant areas of corporate law (Bälz, Dernauer, Heath and Petersen-Padberg 2012).

The supposed harmony of 'Japan, Inc.' has also been threatened by increased shareholder activism since the 1990s, including domestic and foreign hostile takeover attempts and litigation involving leading Japanese companies. A complicated jurisprudence has developed with respect to defences against hostile takeovers, including both court cases and government guidelines, that appeared to seek a middle ground between the board's authority to take defensive measures under Delaware law and the U.K.'s emphasis on shareholder approval (Aronson, Kozuka and Nottage 2016: 109–10). Despite the very rare success of hostile takeover attempts in Japan, the threat has been deemed sufficient to result in a large percentage of Japanese listed companies enacting some type of poison pill to prevent such attempts. A milder form of activist pressure which does not include a takeover attempt has continued with a fair degree of success (Buchanan, Chai and Deakin 2012).

Even the *sokaiya*, one of the main evils addressed by Commercial Code reform during the postwar period, disappeared from the Japanese scene in the early 2000s. Due to both greater information disclosure and a crackdown on *sokaiya* activities, general shareholder meetings in Japan today closely resemble those in the U.S. and other Western countries. There are no *sokaiya* at general shareholder meetings, companies do not focus on the length of the meetings, and companies expect, and even welcome, questions from shareholders (Iwatani and Taki 2010). This

trend casts further doubt on cultural explanations for Japanese corporate law and corporate governance.

4. A NEW ERA? A MULTIPOLAR MODEL AND SOFT LAW REFORM (2008–PRESENT)

The significant, general weakening of the descriptive elements of the J-Firm model, discussed above, raises the important question of its continued viability, and whether there is an alternative, more accurate, means of describing and analysing Japan's system of business governance. Although it may be too soon to give any definitive judgment, it is possible that Japan has entered a new era of corporate law and corporate governance. If the first two waves of reform were inspired by German and American legal approaches, recent years may be characterized as 'multipolar,' with a new, significant emphasis on soft law that is generally associated with the U.K.

This U.K./multipolar influence was in large part a reaction to the financial crisis of 2008, which in Japan continues to be referred to as the 'Lehman shock,' and ensuing criticism of the U.S. model of corporate governance as a global standard. Also, in 2008 the Asian Corporate Governance Association (an organization of institutional investors) issued a white paper that was highly critical of Japan's corporate governance, particularly with regard to the lack of outside directors (Asian Corporate Governance Association 2008). This initiated a new round of government studies and changes that gradually led to the substantial introduction of independent directors in Japan.

These trends were accelerated beginning in December 2012 with the formation of the Abe cabinet and its well-known venture into 'Abenomics'. Japan's growth strategy strongly highlighted corporate governance reform as an important part of structural reform (the so-called 'third arrow', in addition to monetary and fiscal stimulus) that would lead to sustained growth (Headquarters for Japan's Economic Revitalization 2013). Resulting reforms in soft law, and to some extent in hard law, arguably broke with the past emphasis on management flexibility. Everyone seemingly agreed on a new corporate governance goal of improving 'corporate value', with its implied focus on shareholder concerns rather than on management flexibility.

The counterargument against a new era is the lack of a new, distinct model of corporate governance to replace the fading postwar J-Firm model. No one opposes a focus on growth, but the relationship between

corporate governance and business performance remains uncertain. Similarly, the goal of increasing 'corporate value' may be popular precisely because it is vague: it could be interpreted to equate corporate value with shareholder value (Osugi 2011), or, in a Japanese context it could refer to increasing value for all stakeholders (Takei 2010). It may be that Japan is moving in the direction of a kind of hybrid model that combines traditional elements with some additional shareholder-friendly policies and monitoring of management. This will depend in large part on the implementation of recent reform measures. In addition, recognition of a new corporate governance model may, in reality, be inextricably linked to broader economic success under Abenomics, which remains an uncertain proposition.

During this period the prior hectic pace of corporate law reform slowed markedly, as the only amendment to the Companies Act of 2005 was passed in 2014. The biggest issue was again whether to require independent directors for listed companies, and it was difficult to reach agreement. Instead, the law provided for a comply-or-explain approach under which listed companies with no outside directors would need to explain their reasons in the annual report to shareholders. The prior trend of choice in corporate form was continued, as the 2014 amendment added another option, a company which abolished *kansayaku* and instead created an audit committee of the board (a 'one-committee' company). Although these changes were consistent with past practice, the 2014 amendment made a substantial number of other changes specifically to aid minority shareholders, including injunctive relief against fundamental changes in the corporation, regulation of cash-outs of minority shareholders, regulation of large third-party share allocations and a new form of derivative suits by shareholders of parent companies against significant listed subsidiaries to help monitor corporate groups (Kozuka 2014).

The most significant changes during this period were made in a new soft law approach. Over the past several years Japan has adopted this approach in a number of areas, including Tokyo Stock Exchange rules on requiring one independent director or *kansayaku* and on takeover defences, the adoption of a Stewardship Code in February 2014 and a Corporate Governance Code effective from June 2015 (Aronson, Kozuka and Nottage 2016: 111). The Tokyo Stock Exchange also created a new stock index in January 2014, the JPX-Nikkei 400, composed of large Japanese companies with good corporate governance, as determined by measures such as return on equity. Such soft law reforms are generally less objectionable to business and a better 'fit' with an evolutionary, non-mandatory approach to corporate governance reform.

The Stewardship Code is voluntary and recommends constructive dialogue between companies and shareholders. The biggest difference with the U.K. stewardship code was Japan's excusing institutional investors from disclosing individual votes in exercising proxy voting with respect to portfolio companies; however, changes to the code in May 2017 that institutional investors should disclose voting on an agenda item basis, and explain the reasons if they do not (The Council of Experts on the Stewardship Code 2017).

In the Corporate Governance Code, the clearest principle is that listed companies should have two independent directors. Japanese companies are also required to disclose their policies in a number of new and significant areas of corporate governance, including separation of management and monitoring function, advice on nomination and compensation from independent directors (e.g. via committees), succession planning for company president, cross-shareholding and capital allocation.

Both codes have been widely implemented. The Stewardship Code has been accepted by 214 institutional investors as of December 2016 (Financial Services Agency 2017). The percentage of companies which have complied with the Corporate Governance Code's principle that listed companies have two independent directors started at 21.5 per cent in 2014 (prior to the code), leapt to 48.4 per cent in 2015 and to 77.9 per cent in 2016 (Tokyo Stock Exchange 2017).

These codes and their implementation, together with the emphasis on corporate governance by the Abe administration, has accelerated ongoing changes in Japanese corporate governance. Over the last several years even traditional Japanese manufacturers who had most vocally opposed the introduction of outside directors, exemplified by Toyota and Cannon, added outside directors to their boards. The new soft law approach appears to be better suited to Japan, with its tradition of choice and flexibility in corporate law. However, concerns remain about whether the 'voluntary' codes may, in fact, appear compulsory to prominent Japanese companies and, more fundamentally, whether Japanese companies will seriously reconsider important corporate governance issues or whether their code compliance is more a formal matter of simply 'checking the box'.

Compliance with soft law codes and the new 'one-committee' structure under the 2014 amendment to the Companies Act may also serve to accelerate an existing trend towards a hybrid model of Japanese corporate governance. Prior to 2014, a hybrid approach referred to Japanese companies seeking to build on their traditional strengths (including *kansayaku*) by voluntarily adding a number of outside directors and board committees (particularly a nomination committee) (Aronson 2012).

Such efforts attempt to combine insiders' information with outsiders' independence to achieve more effective board functioning, or, in other words, to combine Japan's traditional management model of the board with important aspects of the monitoring model.

There are a number of reasons for this new focus by some Japanese companies on board function over formal structure. One is simply experience—corporate governance scandals have occurred at companies regardless of formal governance structures (Aronson 2017). Even more importantly, there is a business need: a number of large, complex, and increasingly global leading Japanese companies must refocus the board of directors towards strategic issues such as capital allocation among their various lines of business (and away from daily management decisions). One example of voluntary reforms to achieve more efficient decision-making is the substantial reduction in the average number of board members of listed companies to 7.50 members as of 2015 (Tokyo Stock Exchange 2015a: 19), which is a reform that was not mandated by law or stock exchange rule.

Since the enactment and implementation of the Stewardship and Corporate Governance Codes, there is a popular anecdote in Tokyo that there has been a 'change in the conversation' regarding corporate governance, i.e. Japanese companies now engage with shareholders, particularly foreign shareholders, on issues such as dividends and capital allocation policy. This is contrasted to the attitude of Japanese management five years' ago, at which time companies may have dismissed the complaints of foreigners as concerns related to 'short-term' investors rather than to long-term shareholders who consider the best interests of the company. Time will tell if such a trend continues to develop and can be confirmed by data.

5. CONCLUSION

Japan's 150 years of modern history have witnessed frequent and substantial change, including the political, economic and social conditions which form the operating environment for Japanese businesses. Corporate law, and more broadly, corporate governance, has gradually evolved to permit businesses to deal successfully with such changing conditions.

Japan's approach may have appeared to some observers to be rigid, and perhaps even culturally determined, during the postwar period of economic growth and Japan's seeming reluctance to make substantive changes to this model during the subsequent period of poor economic

performance. However, a more historical perspective provides an entirely different narrative: a corporate law and corporate governance system that was flexible and practical, engaged in repeated experimentation to adapt to changing business conditions, and dealt with issues broadly similar to those in other modernizing societies, such as the change from family ownership of corporations to wider ownership. The U.S. also required several decades between identification of the problem of separation of ownership and control by Berle and Means in 1932 until the rise of independent directors to address that issue (Gordon 2007).

In particular, a historical review indicates the lack of long historical precedent of the J-Firm model, and its continuing evolution in the face of changing market conditions. The role of corporate law (and law generally), previously discounted by some observers, has, in fact, become more visible and prominent since 1990. Corporate law revisions and court decisions have been frequent and hotly debated.

Japan has faced two waves of change under foreign influence. The first, German-inspired wave, occurred under foreign pressure to catch up with the West, but was adopted voluntarily to aid Meiji Japan's modernization and developed gradually over decades. The second, American-influenced wave, was a largely involuntary result from Japan's defeat in the Second World War. But even then, despite a rare case in which the occupation authorities presumably had both the authority and the will to undertake a systemic transformation of Japan's corporate law and governance system along the lines of the U.S. model, over time the Japanese adapted and developed their own system in a way which was unforeseen by the occupiers but which was consistent with the Japanese view of the role of corporations in society.

It may be too soon to tell if Japan is now embarking on a third wave of change as a result of the financial crisis of 2008. Although the most influential foreign model appears to have changed to a U.K./multipolar model, the actual effect of changes under soft law, exemplified by the increase in independent directors at listed companies, remains to be seen. Characterization of the current period may also ultimately depend on the uncertain likelihood of success of broader economic and social policies represented by Abenomics.

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PART IV

NORTH AMERICA

16. The evolution of Mexican mercantile and corporate laws

Aurora Gomez-Galvarriato and Gustavo A. Del Angel

INTRODUCTION

Mexico is a large economy that has seen a complex evolution of its legal institutions. Its mercantile and corporate laws have a long history that starts in the 16th century when it was the Viceroyalty of New Spain, under the Spanish Empire. Their history sheds light on Mexico's economic and business history, reflecting the cycles of growth and stagnation, as well as more important economic activities. The history of these laws also provides a new perspective into the difficulties the country has experienced to become and maintain itself as a sovereign nation, and to promote economic development. At the same time, the study of the history of Mexico's mercantile and corporate laws offers new insights into larger questions regarding the factors behind economic development and underdevelopment.

Unfortunately, the history of Mexican mercantile and corporate law has not been sufficiently studied by historians, lawyers, economists or business scholars. Research is needed to provide a deeper understanding about how changes in corporate law interweave with political and economic interests as well as intellectual trends in Mexico.[1] This chapter aims to provide a short contribution to that discussion. With this purpose, this chapter is organized as a chronological account of the main changes in mercantile and corporate law. The chapter does not aim to be a comprehensive description, but rather an informed review of the main developments and their context.

[1] In this approach, the seminal contributions are by Riguzzi (2006, 2005 and 2002).

1. COLONIAL BEGINNINGS

As in other parts of the world, in Mexico mercantile law originated early in the 16th century, having its roots in the legislation intended to regulate overseas trade between the Spanish metropolis and its American colonies. Since Spain's colonial trade was organized as a royal monopoly, it did not give rise to large merchant companies, as was the case in the Netherlands or England (Dari-Mattiacci, et.al, 2017). Instead, due to the importance of mining activity in what then was the territory of New Spain, large companies emerged in this sector, and therefore mining laws, rather than trade regulations, were the main source of innovation in early corporate law in Mexico.

In Spanish America, colonial trade was controlled by the Spanish Crown with the intervention of the *Casa de Contratación* (Board of Trade) in Seville, a private administrative body created for that purpose. During most of the 16th century, trade in New Spain was regulated by the Ordinances of Seville, established by the *Consulado* of Seville. The *Consulados* were merchant guilds organized for the promotion of trade and the defence of their members' interests. They were commercial tribunals instituted by local merchants and acted as arbitration courts to solve mercantile disputes among their members. Disputes were settled using the body of law of the *usus mercatorum* and the written norms prevalent in each *Consulado* (Cruz Barney, 2003: 409). Two or three judges (*Cónsules*) and an administrator (*Prior)* were elected annually among the *Consulado* members to form part of the tribunal. In 1592 the merchants of Mexico City organized their own merchant corporation and issued the Ordinances of the *Consulado* of Mexico. These ordinances ruled trade in New Spain after 1597, complemented when necessary with the Ordinances of Seville and Burgos (León and González, 2007: 39–40).

During the late 18th century, the Ordinances of Bilbao, which were more complete and up to date than other ordinances, became the most important mercantile law. The Ordinances of Bilbao were approved on 2 December 1737 by the King of Spain, Philip II. In 1785, the Viceroy in New Spain ordered that the Ordinances of Bilbao be observed in all aspects that were adaptable to the circumstances of the region. Then in 1792 and 1801 two decrees officially mandated their observance in New Spain. They prevailed in Mexico, at least partially, until 1885.

The Ordinances of Bilbao were elaborated to 'clarify doubts and confusions' in transactions, prevent discord and disputes among merchants, and foresee possible delays and harm that could be originated by

such disputes. They regulated the jurisdiction of the *Consulados*, merchants' and trading companies' operations and the accounting books they should keep, and provided general rules for contracts such as those regarding commercial transactions, commissions, letters of exchange, promissory notes (*libranzas*) and drafts (*vales)*, letters of credit, sales and ship agents, bankruptcies, charter contracts, failures and shipwrecks, and insurance policies (León and González, 2007: 36–40).

The Ordinances of Bilbao gave companies a judicial existence. According to the Ordinances, a company was:

> a contract or agreement between two or more persons by which they reciprocally became obliged for a certain time and under certain conditions and pacts, to pursue together several businesses, under common account and risk, and to each of the partners respectively, according to the share of capital and industry that each of them provided, would belong the losses or the profits (…) that after the period of time established would result from the company (Barrera Graf, 1984: 135).

The Ordinances required the partners to register the contract with a public notary, including personal information and the contributions that each of the partners would provide either in capital, goods or industry, and to give a copy of the contract to the *Consulado*. However, lack of compliance with this requirement did not nullify the contract. It was always a temporary contract and in cases where one of the partners decided to exit the company or died, a new contract had to be made. The responsibility of the partners who were not involved in management of the company was limited to their contribution to the company, since the Ordinances established that partners had the duty to cover losses 'up to the quantity of capital and profits that could have resulted from the company'. However, the responsibility of the managers was unlimited: 'those under whose signature the company is run are obliged, besides the capital and profits that belong to them, with all the rest of their patrimony to support the losses …'. (Barrera Graf, 1984: 136).

Like all *ancient regime* merchant law, 'it was a law of market transactions, concerned almost exclusively with the flow of goods and services between independent economic entities; intra-organizational economic relationships were almost wholly ignored' (Means, 1979: 320–21). Although it regulated business associations, the Bilbao Ordinances' provisions concerned principally the companies' external legal relationships, such as the partners' liability for company debts. Since business associations in Mexico were typically small, the transfer of internal resources did not represent an important problem. The only sector in which companies were larger and more complex was mining,

but these companies had a special set of legal rules that regulated them, the mining laws.

The first mining laws were promulgated in 1584 and were commonly known as the *New Code*, to distinguish them from previous ordinances (de Gamboa, 1830: iii). The New Code established that mines could be held in companies, admitting a variety of different agreements. The law divided mines into 12 or 24 shares (*barras*) for better regulation of the company, and it was obligatory to those who registered a mine held as a company to identify the partners and the shares each of them held. These early companies were business organizations well-adapted to the institutional environment in which they operated, where labour was recruited through coercive institutions such as the *encomienda* and the *repartimiento* rather than a labour market. Thus, in order to form part of the company, the partners had to provide a share of the workers and their expenses, instead of providing a share of the capital, as would be the case in modern firms. The ordinances established mechanisms to settle disputes among partners that should be solved by a mining judge, and set rules to divide the product of the mines corresponding to the *barras* each partner held of the mine, as well as penalties in case partners did not comply with their duties (de Gamboa, 1830: 165–8).

Later, two organizations to regulate and promote mines were established, the Supreme Council of Mines of New Spain, in 1777, and a School of Mines shortly thereafter. Then in 1783, a more modern code, the Royal Ordinances of Mines of New Spain, was promulgated to simplify and standardize the mining laws. Although they were originally conceived to regulate the mines of New Spain, the 1783 ordinances were adopted by the other mining districts of Spanish America. Some important changes introduced by the 1783 ordinances were the establishment of the *Tribunal General de Minería*, and the *Diputaciones de Minería*, or general and local tribunals to which the exclusive jurisdiction in mining affairs were confided, and the establishment of a mining bank (*Banco de Avíos de Minas*). The *Tribunal General de Minería* was an association of miners, equivalent to the *Consulado* for merchants. The authorities of the General Tribunal of Mining and the Mining Deputies were miners elected among its members. Its establishment emancipated mining from the state in government matters, and from the *Audiencia* in judicial matters (Contreras, 1996: 40).

The Mining Ordinances stated that companies that exploited mines should be encouraged, promoted and protected, and that the Viceroy should grant those who formed companies 'every favor, aid and exemption which can be granted to them, according to the judgment and discretion of the Royal Tribunal of Miners' (Chapter XI). They expressly

took account of the form 'company with shares', and laid down some rules regarding their internal organization. The companies contemplated were closer to the modern corporate firm, than those established by the 1584 ordinances, since partners became so by subscribing to part of the capital. However, partners also had to contribute regularly for expenses in proportion to the shares of the mine they held. The Mining Ordinances also established that the partners had to be subjects of the Spanish empire.

Under the new ordinances mines continued to be divided into 24 (fictional) equal parts (*barras*), but each of these could be subdivided into suitable smaller parts. In order to avoid disputes, the ordinances established that all the measures necessary to be taken had to be determined by plurality of votes with the intervention of one of the members' local or district tribunal, who should endeavour to preserve harmony among the parties. The votes had to be valued and counted according to the shares (*barras*) which each partner possessed, but the ordinances protected minority shareholders by providing that, if one partner possessed 12 or more shares, he should have a number of votes less by one than half the number of the shares. Shareholders could sell their shares to a third party without the consent of the other partners, but existing partners had the right of first refusal. If one of the partners died the partnership interest was transferred to his heirs.

The Mining Ordinances also regulated the relationship between the mine-owners and their contractors, or mine-suppliers (*aviadores*), who also were money lenders and an important source of capital and liquidity for the mines. The ordinances specified two methods by which *aviadores* could be repaid for the supplies they advanced. In one of them, called *aviar a premios de platas*, the owners allowed the mine-suppliers to extract gold and silver at a price somewhat below its real value, leaving the contractors the benefit of the difference. In the other method, later named *avío con translación de dominio*, they gave the contractor a share in the mine, 'making him a perpetual proprietor thereof, or of the metals for a certain time, in a form of company' (Chapter XV). In this case, the capital invested by the supplier could not be immediately deducted from the profits and given to him, but he would receive profits, like other shareholders, in proportion to the number of shares he held in the company. Through this means, the ordinances established an organizational form similar to the corporation or joint-stock company with variable capital. In order to shield the mining company from interference by the *aviadores*, they could not interfere directly in the management of the mine. Yet, they had the right to appoint an inspector (*inteventor*) to any mine-owner whom they had contracted to supply. The inspector

could only attend to the correctness of the accounts but could not interfere with or obstruct the working of the mine.

These regulations provided a way to commit long-term capital but also gave investors the right to unilaterally withdraw their capital. At the same time, they provided rules that limited agency problems in the companies' governance that were implemented by the Tribunal of Miners. The members of the tribunal were elected among miners, limiting the role of the government and the threat of expropriation. Moreover, the ordinances also established a modest form of limited liability for mine-owners. They indicated that 'Mine-owners shall not be liable to be arrested for debts' and that in case of bankruptcy, 'in the interval during which the silver extracted therefrom is being applied in satisfaction of the debt', the owner should 'receive out of the produce what is absolutely requisite for his support, according to the circumstances of his family and condition' (Chapter XIX).

Mexican commercial law evolved slowly during the 19th century. Mexico became independent from the Spanish crown in 1821, and in the absence of national legislation, the Ordinances of Bilbao continued to be applied. In October 1824, the *Consulados* were suppressed and it was mandated that commercial disputes should be resolved by judges in general courts under current legislation. However, given that no new commercial laws were passed, lawyers continued to rely on the Ordinances of Bilbao and other Spanish legislation. Even Spanish laws enacted after Mexico's Independence, such as the Spanish Commerce Code of 1829 and the *Ley de Enjuiciamiento Civil* of 1855, although with no legal force in Mexico, were frequently invoked by Mexican lawyers and courts. Mexican legislation that appeared during the first half of the 19th century such as the Civil Codes of Oaxaca and Zacatecas of 1829 added to the former regulation in the states where they applied (Barrera Graf, 1984: 139–41).

Similarly, the mining laws that existed before independence remained in place, with a few modifications to fit them to a republican and a federal form of government. The General Tribunal of Mining was abolished and its functions were devolved onto the local mining tribunals of each state. In 1823, a decree promulgated by the Mexican Congress, allowed foreigners to hold shares in the mines that they furnished with supplies of capital or goods (de Gamboa, 1830: vol I, p.vi; Thomson, 1825: 194).

In 1841, Mexico's President, Antonio López de Santa Anna passed a decree organizing Development Boards (*Juntas de Fomento*) and Commercial Tribunals (*Tribunales Mercantiles*) to replace the *Consulados*. The Commercial Tribunals dealt with all commercial disputes and

compelled companies and merchants to register their businesses with the local Development Boards. This decree encompassed several organizational forms of mercantile companies, but did not include the joint-stock company or corporation (later labelled *sociedad anónima, 'SA'*). Following the Spanish Code of 1829, firms had to submit a copy of their statutes to these boards (Orozco, 1911: 94–5, Cruz Barney, 2003). According to this decree, the Ordinances of Bilbao would apply to commercial matters until Congress passed a national commerce code.

Ancient regime commercial law in Mexico was not so different in practice from that of common law countries. Lawyers and judges structured their arguments based not only on the articles of the Ordinances of Bilbao or any other code, but also on the jurisprudence that had been built up through decades of similar cases, forming a vast legal culture written down in several manuals and treatises. In practice, Mexican lawyers, jurisconsults and judges were extremely influenced by legal treatises written in Spain, basing their knowledge of the subject on classical Spanish legal works that were adapted to Mexico and printed there, such as Hevia Bolaños's *Curia Philipica* and Eugenio Tapia's *Elementos de Jurisprudencia Mercantil* and *El Febrero Reformado* (Barrera Graf, 1984: 139). This last book, published in Mexico as *El Nuevo Febrero Mexicano* (Galván, 1851) contained several standard blueprints of charters for the types of firms that were used in practice in Mexico, even if not regulated by any specific Mexican code. *El Febrero Reformado* included three types of organizational forms: personal, collective (partnerships) and *commanditariae* (limited partnerships), and showed different ways to limit liability (mainly in favour of the *comanditario* or silent partners), several arrangements for the distribution of profits and losses, and means to restrict the competence of some partners in specified aspects of the partnerships (Barrera Graf, 1984: 142).

2. LIBERAL LEGISLATION

Like most Latin American nations, Mexico codified its commercial law in the second half of the 19th century. In this process, the influence of French civil law and its method of codification was fundamental. Thus, in May 1854, Mexico promulgated its first Code of Commerce (*Código de Comercio)*. The Code adhered to the European tradition of exhaustive and comprehensive codifications of laws (Zamora, et.al., 2004: 448). It was profoundly influenced by the Spanish Code of Commerce of 1829. Both codes resembled the French *Code de Commerce* of 1807 in many aspects but were, in relation to corporate law, even more advanced

(Barrera Graf, 1988: 138). Mexico's Code of Commerce of 1854 was extremely progressive for the time because, like the Spanish Code of 1829, it embodied the principle of general incorporation (Guinnane and Martínez-Rodríguez, 2014: 87). Under this system, companies could enter the market when the local tribunal of commerce approved their statutes (a mere administrative procedure), without requiring an approval by the government (art. 253). While Spain temporarily abandoned general incorporation in 1848, Mexican legislators chose to keep free incorporation in the Mexican code (Keinan et al., 2002: 842).

The Mexican Code of Commerce of 1854 offered a menu of three organizational forms: the partnership *(sociedad en nombre colectivo)*, the limited partnership *(sociedad en comandita simple)* and the joint-stock company or corporation *(sociedad anónima–SA)*.[2] It established the basic principles of each type of organization, but did not have the more detailed regulation regarding the existence, governance and finance of these ventures that later codes included. The Code mandated the registration of such organizations in the Public Registry of Commerce (*Registro Público de Comercio*). The Registry had to maintain a public record of registered merchants, as well as a record of their specific transactions. It was necessary for firms to register to secure the enforceability of business deals, since certain commercial transactions were not binding on third parties unless they were in that registry. Although research needs to be done to measure the impact of the Commerce Code of 1854, it appears that it was small. Unlike Spain, where the liberalization of entry requirements was followed by a founders' boom, in Mexico, as in Colombia, it seems to have had a negligible impact on economic development, since very few corporations appeared in the following years (Martín Aceña, 1993; Keinan et. al., 2002: 842–6; Riguzzi, 2006: 6–7).

Moreover, the Code of Commerce of 1854 had a very short and haphazard life. Up to the 1870s, Mexico experienced political turmoil and shifting governments, with unsteady rotation between liberal and conservative political factions. Subsequently, the Code was rescinded only 15 months after its enactment, when the liberals took power, since they believed the commercial tribunals were related to the *fueros*—special substantive rules that granted privileges to specific groups—which they opposed. In 1860 when the conservatives took over the government, the code was briefly applied, until the liberals again soon regained power. However, in 1863 the code was once again decreed to be valid after the

[2] For the organizational forms, see Guinnane and Martínez-Rodríguez (2014).

French Napoleonic army occupied Mexico City, placing an Austrian prince, Maximilian of Habsburg, as the head of a Mexican Empire (Means, 1979: 303–6). The restoration of a Republic in 1867 marked the end of the Code of Commerce of 1854, at least as nationwide legislation. However, several states adopted the code, such as Puebla, the state of Mexico, Guanajuato, Veracruz, Aguascalientes, Hidalgo and Morelos, but Mexico City did not adopt it[3] (Barrera Graff, 1984: 144–5; Means, 1979: 307). It took almost 17 years following this for a new Commerce Code to be enacted, which made Mexico in 1881 (when Honduras passed its Commerce Code) the last country in Latin America that continued to be ruled by the Ordinances of Bilbao. Hence in this development, Mexico lagged relative to other Latin American countries of that period (Means 1979).

In 1883, the Mexican Constitution was amended to grant the federal Congress exclusive power to legislate in the field of commerce, mining and banking. This enabled Mexico's Congress to pass at the end of the year a new national Code of Commerce, known as the Code of Commerce of 1884. 'The decision to make commercial law an exclusive federal concern was an important factor in standardizing commercial practices throughout the nation, warding off potential conflicts of law between different states' (Zamora, et al., 2004: 532). Federal exclusivity applied to 'substantive law', including the identification of merchants, forms of business organizations, acts of commerce, public registry of commercial acts, bankruptcy and certain procedural aspects. Thus, the Mexican law of corporations became entirely federal: all corporate charters had to be granted pursuant to federal law, and thereafter no state laws directly affected this matter (Zamora, et al., 2004: 567). However, federalizing commercial law did not result in absolute federal control over commercial practices, since commercial litigation remained a matter of concurrent jurisdiction, and either state or federal courts remained competent to hear matters stemming from commercial disputes, at the discretion of the plaintiff.

Unlike the Code of 1854 that was the work of a single man, Teodosio Lares, Minister of Justice, this code was produced by a three-man codification commission appointed in 1867, and these proposals were discussed in Mexico's most influential legal journals (such as *El Foro*) and in Congress. The code was influenced by the evolution of chartering laws in other civil law countries, especially France and Spain, but

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[3] The Civil Code of Veracruz of 1868 and the Civil Code of 1870 show that the regulation of mercantile societies was ruled by the Code of 1854.

included important innovations. Instead of the brief description and regulation of firms in the Code of 1854, the Code of 1884 included 276 articles that outlined the regulation for each organizational form. This Code replaced the traditional 'subjective' structure of mercantile laws, adopting the 'objective' French model of commercial acts. Thus, instead of placing greater emphasis on the characteristics of the businessman or merchant, the focus shifted to the act of commerce itself (Zamora, et al, 2004: 449).

The Mexican Code of Commerce of 1884 expanded the range of organizational choices available to businesspeople and facilitated market entry. It introduced the limited partnerships with tradable shares (*sociedad en comandita compuesta*), which limited the liability of its partners to the face value of their stock. More interestingly, it created a type of private limited liability company (*sociedades de responsabilidad limitada—SRL)*, similar with the GMbH (Gesellschaft mit beschränkter Haftung) that would appear in Germany in 1892 or the SARL (Société à Responsabilité Limitée) that appeared in France in 1925 and became so dominant in the 20th century (Guinnane et al., 2007). The SRL gave all partners limited liability, but unlike the corporation it did not allow them to trade shares anonymously on a stock market. The advantage of the SRL over most partnerships was that all the partners could get limited liability. The code established this form as a simplified and smaller type of joint-stock company or corporation (*sociedad anónima*) with limited liability for shareholders but without tradable shares, as *sociedad de responsabilidad limitada* shares should include the name of the owner (the only difference between the *sociedad de responsabilidad limitada* and the limited liability partnership was that there was no need to have a partner with unlimited liability). The law established a maximum capital of 300,000 pesos for this type of company and required it have at least seven partners (Barrera Graf, 1984: 142; Mantilla, 1946: 246–7).

This organizational innovation did not last long because in April 1888 private limited liability companies and corporations were merged into a single corporate charter. The new Joint Stock Company Law (*Ley de Sociedades Anónimas*) of 1888 mandated that corporations (*sociedades anónimas*) and private limited liability companies (*sociedades de responsabilidad limitada)* adopt the general corporate form (Barrera Graf, 1984: 153).[4] The Joint Stock Company law regulated the value of shares, their denomination (nominal or bearer shares) and the procedure to call

[4] The private limited liability companies did not appear again in the Mexican menu of organizational forms until 1934.

capital. It also established three bodies to regulate the functioning of corporations: the shareholders' assembly, the management and the shareholders' auditing body (*comisarios*), adopted from Italian legislation. Finally, it laid out regulations for ordinary and extraordinary shareholder assemblies, established a reserve fund, mandated annual disclosure of balance sheets, and laid out the procedure for bankruptcy and liquidation.

In 1884 Congress also passed a Code of Mines which replaced the colonial Mining Ordinances of 1783. It was a liberal law that in contrast to previous legislation established that the owners of the land held also the ownership of the sub-soil resources. In this law, exclusive to mining companies, legislators introduced an organizational form similar to the *sociedad anónima* with some minor variations that resembled those of the Mining Ordinances. It replaced the system of *barras* with bearer or registered shares, but retained from the Mining Ordinances the rule that shareholders would have their shares voided if they did not contribute their share of the expenses or did not cover their contributions. In contrast, it clearly established that the responsibility of the shareholders was limited to the value of their shares. It also retained from the Mining Ordinances the one-share-one-vote provision but established a cap on the maximum number of votes at 49 per cent of the total (Barrera Graf, 1984: 152).

In 1892 a new Mining Law was promulgated that introduced the need for a concession granted by the state in order to establish a mine. It established that mines should adopt one of the business forms established by the Code of Commerce and forbade other forms of association. This was considered a grave mistake by Mexican lawyers of that time since mining business was more volatile than other types of business and therefore mining companies could not establish a fixed amount of capital as required by the Code of Commerce. According to them, the common practice of financing mines through the *avío a premio de platas* or the *avío con traslación de dominio* did not fit the forms regulated by the Code of Commerce, and thus created grave juridical problems (Reyes, 1901: 42–5). In response, most mining companies registered abroad since the Mining Code did not require that they were established under Mexican laws.

In September 1889, President Porfirio Díaz promulgated a new Commerce Code that came into effect on 1 January 1890. This new code merged the Commerce Code of 1884 and the Joint Stock Company Law of 1888 into one document. The Code of Commerce of 1889 followed the European model of commerce codes, such as the French Law of 1867, the Italian Code of Commerce of 1882 and the Spanish Code of Commerce of 1885. It defined five different types of organizational

structures: partnership (*sociedad en nombre colectivo*), limited partnership (*sociedad en comandita simple*), corporation (*sociedad anónima*), limited partnership with shares (*sociedad en comandita por acciones*) and cooperative (*sociedad cooperativa*).[5] The new code also required firms to have a registered public contract (*escritura pública*) when they were established or when the contract was amended.

The Mexican Commerce Code of 1889 was, in many ways, more flexible (enabling) than similar codes in other civil law countries.[6] The flexibility of the Mexican code stems from three principles Mexican legislators considered fundamental: ample freedom for partners to constitute their firm according to their interests; the complete absence of government intervention in the internal operation of the firm; and publicity of all actions that could be of interest to third parties (Moreno 1905, 161). However, it did not adopt the principle of *numerus apertus* of the Spanish Code of 1885, that allowed more flexibility in the forms companies could take, but kept the principle of *numerus clausus* from the former codes (see Guinnane and Martínez-Rodríguez, 2014: 88).

Moreover, in terms of transparency of firms, the Mexican Commerce Codes fell short, since, although they required corporations to publish their annual balance sheet, and profit and losses statements, it did not establish a sanction for not complying with this norm. Thus, very few corporations in Mexico published their annual balance sheets or any other relevant company information. According to Riguzzi (2006: 14), between 1900 and 1910 only between 3.9 and 7.3 per cent of all corporations (in all sectors but mining) registered in Mexico City published their annual balances, and only between 50 and 67 per cent of those corporations with shares traded in the stock market did so. This flaw in Mexican law might have increased the adoption of corporations relative to other corporate forms, but at the cost of poorer development of a stock market and of less protection of the rights of minority shareholders.

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[5] A version of the 1889 Code that compares every article of the law with the legislation of other countries provides evidence for this matter.

[6] Enabling law makes most of the statutory provisions optional and allows parties to reallocate control rights (Keinan et al., 2003, 9). For example, as in other civil law countries, the Mexican Código de Comercio of 1889 set a requirement of a supermajority shareholders vote to increase or decrease capital, something considered mandatory (unflexible) by Keinan et al., but it opened the possibility for an alternative arrangement, since it stated that this applied only *when the company statutes did not establish something different.*

An important difference between the 1884 and the 1889 Commercial Codes was that the first only considered individuals as merchants, while the latter included companies, including foreign corporations, as merchants subject to the Code (Zamora, et.al., 2004: 449). Another important difference was that the 1889 Code replaced the 42 articles that referred to banking companies in the Code of 1884, with only one article that established that the credit institutions were going to be regulated by a special law. The first bank law in Mexico, the *Ley de Instituciones de Crédito* (Law of Credit Institutions), was promulgated in March 1897, and regulated three types of banking institutions: banks of issue, mortgage banks and development banks. Other types of credit institutions continued to be regulated solely by the Code of Commerce.

The Code of Commerce of 1889 still prevails until today, but it has been reformed substantially so very little of the original version remains (Soberanes, 2015: 201). Rather than attempt to carry out multiple amendments to the Code of Commerce, Congress has chosen to pass specialized legislation on many types of commercial activities that takes precedent over the Code of Commerce. Thus, the Code of Commerce serves primarily as a source of procedural rules governing commercial litigation, as well as a source of supplementary rules applicable to those commercial activities that are regulated by more specific laws (Zamora, et al., 2004: 450).

In the late 19th century, an early stock exchange, the Mercantile Exchange of Mexico, began to operate in 1886. However, the predecessors of the current stock exchange in Mexico were founded in May 1895, the *Bolsa Minera* and the *Bolsa Nacional* (they merged soon after). The promulgation of the Commercial Codes and the Mining Codes which allowed the granting of property titles on mines and the formation of mining negotiations motivated their formation (Cárdenas and Del Ángel 2011). However, in comparison to other stock exchanges in Latin America during that period, such as the Brazilian, very few companies traded on Mexico's exchanges, and the stock market was not a relevant source of capital for businesses (Haber, 1997). Historically, the Mexican securities market has been small compared to those of similar economies.

3. LAWS UNDER A NATIONALIST ENVIRONMENT

In the decades after the Mexican Revolution (1910–20) a nationalistic ideology marked the evolution of commercial and corporate law. The Constitution of 1917 imposed important restrictions on foreign ownership of land and limited foreign participation in companies in several sectors

of the economy; its article 27 provided that the state may grant the right to own property to foreigners only if they agreed to consider themselves Mexican nationals with respect to government with regards to that property. This provision is known as the 'Calvo clause', named for the Argentinian jurist Carlos Calvo who developed it, and stood as a principle of resistance to the political and military power that was occasionally brought to bear by foreign investors and their governments against acts taken by the Mexican government (Zamora, et.al, 2004: 577). The Constitution of 1917 also forbade corporations (*sociedades anónimas*) from buying, possessing or managing rural property for agricultural purposes.

In terms of the history of corporate laws, the General Law of Mercantile Societies (*Ley General de Sociedades Mercantiles, LGSM*), promulgated in 1934, is particularly important. A project for this law presented in 1929 by the Ministry of Industry proposed that the new law adopt as its basis the principles of Anglo-Saxon legislation, to create a more flexible legal framework that would allow rapid development of the corporation. However, in 1934, those in charge of writing the new law considered that the approach was inadequate given that a general sentiment of mistrust towards the corporations prevailed among society. They explained in their introduction to the law, that establishing rules that expanded too much the scope of action of the founders of corporations would only increase mistrust towards them. Thus, they decided to preserve much of the rigid structure that the Code of Commerce gave to the corporation. Accordingly, the Mexican corporate law continued to be marked by its attention to formal details. The LGSM continued to require business organizations to be chartered by a public notary (*notario público*), who could either grant the organization a charter or deny it, based on whether its incorporation met the requirements of the law. The LGSM also continued to state that corporations or limited partnerships were recorded in the Public Registry of Commerce of the region where the corporation had its address, as an essential requirement to give them a legal status, distinct from that of the shareholders or partners (Zamora, et al., 2004: 568–74)

To provide more flexibility than previous regulations, the legislators included an additional type of business organization: the private limited liability company (*sociedad de responsabilidad limitada, SRL*), which had briefly existed in the 1880s, and they allowed all types of business organizations to be constituted with variable capital (Mexico, 1934: 3–4). The SRL provided limited liability for partners, whose interests were represented by shares with limited transferability (Zamora et al., 2004: 603). Since there were fewer legal requirements for the establishment and

administration of SRLs compared to SAs, legislators hoped that the new business form would encourage the development of medium-sized companies, as had happened in England (with private companies), Germany and France. However, this did not happen in Mexico because the lack of government control and vigilance over compliance with the law meant that most new firms preferred to constitute as a corporation, since that gave them the possibility of an unlimited number of partners and ample and expeditious circulation of the company's capital (Barrera Graff, 2014: 370). The reason why several SRLs were established was to avoid the limits that the 1917 Constitution placed on corporations' ability to own rural land.[7] Later on, this form was also often chosen by foreign investors because SRLs enjoyed lower tax rates in the U.S. than publicly traded stock corporations, and because its legal regime was strict enough for parent companies to be able to maintain control of the branch companies (Zamora, et al., 2004: 603). The LGSM also offered the possibility that all societies could be constituted with variable capital. In a fixed capital corporation, a fixed amount is established as the capital, while in a variable capital entity the variable portion of the capital stock may be increased or decreased without amending the corporate charter, as long as it is expressly permitted by the company's charter or by-laws (*estatutos*), and the fixed portion of the stock does not fall below a stated minimum (Fernandez, et al, 2001: 162). Therefore, most major corporations in Mexico have been incorporated as variable capital stock companies, or *sociedades anónimas de capital variable, S.A. de C.V.* (Zamora, et al., 2004: 585).

Another innovation of the LGSM was that it allowed important exceptions to the rule that all shares must have equal value and confer equal rights on all shareholders. Its article 112 allows shareholders to agree that capital stock may be divided into several different classes of shares, and that special rights may be granted to the holders of each type. Thus, the articles of incorporation may limit the rights of the holders of certain classes of shares to only one right: the right to vote at extraordinary shareholders' meetings where fundamental matters are decided. As a compensation, the law established that the shares with limited voting rights should give shareholders priority in the payment of corporate dividends, and they may receive higher dividends than the shares of common stock (Zamora, et al., 2004: 582).

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[7] In 1992 a reform to the Constitution allowed mercantile companies with shares to own rural property for agricultural activities but established limits to them.

The system adopted by the law regarding corporations is liberal, giving great autonomy to organizers who are allowed to introduce agreements and additional systems (such as that of variable capital), or even to derogate some norms included in the law, although some provisions are mandatory and others limited by the requirement that they cannot damage third parties. It is considered that the principle of autonomy allows in practice too much flexibility that many times permits abusive practices. This is the case, for example, when some clauses, included by shareholders' agreements directly or indirectly restrict the free circulation of shares, undermine public credit or harm the interest of creditors. These clauses sometimes permit simulation and fraud by the lack of administrative and judicial control, for example in the case of withdrawal of capital contributions, arbitrary pricing of the value of property, or the rights granted, increases or reductions of capital by revaluation of assets, etc. (Barrera Graff, 2014: 396).

Many of the flaws and omissions of the law are a result of its age. When it was promulgated many present-day problems were not an object of regulation since they were unknown both in Mexico and abroad. That is for example the case of the regulation of business groups, or the public offer of shares in the stock market. Other flaws can be attributed to the law of 1934 itself. One of its most salient problems was that lack of a requirement of the intervention of an external body, either public or private (such as the Colombian Superintendence of Corporations, the Argentine Inspection of Justice or the Chilean Superintendence of Securities and Insurance), to control and supervise the compliance of the legal precepts, and the respect of the different interests, both in the constitution and in the operation of the different types of societies and specially of corporations (Barrera Graff, 2014: 397). Given the weak legal infrastructures that prevail in Latin American countries, the allocation of important supervisory, correctional and even judicial powers to administrative agencies has been considered a last resort interim solution to the long-lasting and ineffective judicial processes of Latin America. The technical expertise of these agencies as well as the proceedings they have developed during the last decades have been more useful in handling corporate law conflicts than the ordinary courts (Reyes, 2008: 265).

Another important problem with the LGSM, was that it did not modify the surveillance authority established in the Code of Commerce, keeping it as subordinated to the shareholders' assembly, without real independence from the board of directors nor any effectiveness in practice. As in the former Code, the law requires that every legally chartered company provide for oversight by one or more *comisarios* (examiner/auditors),

appointed by the shareholders by a majority vote (although the law permits corporations to adopt rules that give a minority of shareholders the right to appoint at least one *comisario*). Since the independent audit is a key element in the transparency of a corporation's financial state of health, the model of 'semi-independent' auditing adopted in Mexico reflects that transparency has not been highly valued (Zamora, et al., 2004: 592).

Finally, the LGSM established a system in which the shareholders of a Mexican corporation exert a greater influence on directors than other laws, such as that of the U.S. Similarly, it accorded considerable more rights to majorities, thereby limiting the minority shareholder's influence over management of the corporation, unless the latter was granted additional protection by the company's bylaws. As in other countries in Latin America, this system allowed, as a matter of statutory right, that majority shareholders in corporations could impose their will on the minority (Fernandez, et al., 2001: 160–63).

In the 20th century, Mexico witnessed increasing complexity in its economy. The LGSM and the Code of Commerce were the basis for the numerous new statutes that emerged to cope with a gradually more sophisticated economy (León and González, 2007: 44–5). Starting in the 1940s, Mexico experienced an expansion in the creation of new firms as a result of sustained economic growth for several decades and a process of industrialization and greater urbanization of the country. This represented a transition from businesses that were conducted in a way that nowadays could be considered 'informal', to registered companies, established under a legal instrument (Derossi, 1971).

The corporate form established in the LGSM allowed business families to diversify investments, expand funding sources and separate personal assets from business risks (Castañeda 1998). Nonetheless, legislation underestimated a central element in business organization in Mexico, family ties, which have long been an important component of Mexican corporate governance. At the beginning of the 1970s, although 92 per cent of companies were registered as corporations, it was estimated that in only 46 per cent of them were no relatives involved. In 13 per cent relatives served on the board, 25 per cent had relatives in executive positions and 16 per cent had both relatives on the board and in executive positions. It was also estimated that 64 per cent were companies with concentrated ownership (Derossi, 1971). Family ownership of large firms is prevalent today. A study has found that less than 25 per cent of the chief executive officers of the 90 largest Mexican corporations also serve as the chairmen of the board. Usually, the founder or a senior family member (usually ex-CEO) is still tied to the company and serves as

chairman of the board, while a younger family member acts as CEO (Husted and Serrano, 2001).

The structure of family ownership was combined with the fact that, throughout the 20th century, large Mexican companies were parts of conglomerates or *business groups*. These groups were the result of vertical and horizontal integration, in the latter case in order to diversify risk. The groups could include several families of entrepreneurs, nevertheless it was usual that there was a dominant family or entrepreneur. This structure in turn limited corporations' openness to participating in the stock exchange, but it was not an impediment to it (Basave, Morera and Strassburger, 1994).

During the 20th century, business groups moved towards more formally-defined group or conglomerate structures. This led large business groups to evolve towards a centralized structure, with one company coordinating the rest. At first, business groups were controlled and coordinated by companies that held shares of other companies in the network (holding firms or *controladoras*, as were known in the law). Over time, holding companies became more common. In other words, many of the largest groups that were networks of companies without any defined organization, began to acquire structure through forming holding companies, establishing legal and administrative bonds between firms, and adopting the legal trademark that identified them as a single group. These developments were motivated by changes in the law towards the end of the 1960s (Castañeda, 1998).

Also, since the 1940s the largest business groups had contained financial units, which were constituted by one or more interconnected financial intermediaries. The governance of these intermediaries was established in 1941 by the Banking Law (*Ley de Instituciones de Crédito y Organizaciones Auxiliares*), which had stricter criteria for management and control than the mercantile law (Del Angel, 2016). The financial arms of business groups were composed of several financial intermediaries because the Banking Law established the separation of functions between them. However, these intermediaries worked together, to serve the needs of the owner groups as well as operations with other clients. Consequently, since 1970, reforms to the Banking Law gradually recognized interconnected financial intermediaries, introducing a legal instrument called 'financial groups'. Those financial groups were different and separate from the business groups they belonged to (Del Angel, 2016). When the banks were expropriated in the government in 1982, financial groups continued to use non-bank financial intermediaries. In 1990, after the re-privatization of banks, the Banking Law was reformed to allow commercial banks to be part of financial groups, but it

established a strict separation of financial intermediaries from the non-financial interests of proprietor groups.

It is important to highlight that during the 20th century, the state played an active role in the process of industrialization through state-owned enterprises. Mexico's government owned firms in multiple sectors of the economy, because they were considered strategic (such as oil and electricity), or to preserve jobs in industries or regions. These companies were expropriated, acquired or established by the state. The number of state-owned enterprises increased, reaching a disproportionate growth in the 1970s. There were also joint ventures between the state and private business parties. In the mid-1980s the government began to reduce its participation in the economy, divesting from many of its enterprises. This cycle of state ownership of companies was not different from international trends, and an example were Latin America's biggest economies (Musacchio and Lazzarini, 2014).

State-owned enterprises and enterprises with partial participation by the state were important customers and suppliers of private companies. This created a peculiar governance situation. Namely, some of these state-owned companies were incorporated as corporations, but others were branches of government agencies. Their structure of corporate governance was ruled mainly by the Law of the Federal Public Administration (*Ley Orgánica de la Administración Pública Federal*), and by the Mexican Constitution, which from its origins in 1917 established the industries reserved for the government, as well as economic activities in which the state had to exercise dominance (*rectoría*). The Constitution was modified on several occasions to increase these sectors and economic activities until the mid-1980s (Barrera Graf, 2014).

Equally complex was legislation regarding foreign companies. After the Mexican Revolution, the government always sought a legal framework for foreign companies operating in the country. Between the 1930s and the 1980s, considered to be an era of a closed economy, the regulation of foreign investment in Mexico became increasingly stringent. However, many companies in Mexico were foreign or had foreign investment. This situation added variants to the corporate governance of the Mexican firms, since in addition to the direct authorizations for foreign companies to operate in the country, there were associations and joint ventures between Mexican entrepreneurs and multinational corporations. For example, local firms and entrepreneurs represented these corporations, or there were associations between both. There were also Mexican companies that had foreign investment in their capital, for historical reasons, as was the case with some banks until 1982. This

implied that foreign parties had representation on boards and participated in management.

Regulations were passed in the form of secondary rules to regulate the participation of non-Mexicans (individuals or corporations) in firms operating in Mexico. The Banking Laws of 1932 and 1941 settled a precedent to restrict participation of foreigners in business. Nonetheless, foreign investment continued to be accepted in Mexico, and was important in certain sectors, such as in petroleum and mining. The expropriation of the oil companies in 1938 brought an end to foreign investment in that sector, a prohibition that remained in place until recently. Although in most sectors foreign investment was permitted, 'it operated according to a series of restrictions that emanated from presidential decrees issued during the Second World War for national security purposes' (Zamora, et al., 2004: 576). In general terms, restrictions followed the principle that foreign participation in an enterprise should not exceed 49 per cent of its stock. However, there were many exception and diverse arrangements. In 1973, Congress consolidated these decrees into a single law, the 1973 Law to Promote National Investment and to Regulate Foreign Investment (*Ley para Promover la Inversión Nacional y Regular la Inversión Extranjera*) (Zamora et al., 2004: 576). This law substantially increased restrictions on the participation of foreign capital in companies operating in the country. This led to foreign corporations selling their shares in Mexican companies. Such divestiture gave a significant boost to the stock market, and consequently the ownership structure of these companies changed. This reconfiguration was due to the fact that many of the shares were sold to individual Mexican entrepreneurs or business groups that became the new controllers, but others were left in the hands of institutional investors, specifically trust funds in Mexican banks (Cárdenas and Del Ángel, 2011).

The processes regarding the formation of business groups and financial groups, the participation of state-owned enterprises in the economy and the changes in foreign investment, were reflected in the Mexican securities market. The securities market certainly reflects the interaction between corporate practices and the laws that govern Mexican corporations, at least for the largest companies. In 1933, a relatively more modern exchange than that which operated in the 19th century was established, the Securities Exchange of Mexico (*Bolsa de Valores de México*), and the Securities Exchange Regulation (*Ley Reglamentaria de Bolsas*) was enacted. That law was effective until 1975. In 1954, the Investment Funds Law was passed (*Ley de Sociedades de Inversión*). It is believed that the formation of a regulatory framework contributed to the increase of traded stocks and economic growth. However, the stock

exchange had its most significant regulatory change in 1975, when a Securities Market Law (*Ley del Mercado de Valores*) was issued in January of that year.

Until the 1970s, a few firms issued stock traded in the securities market. The 1975 law responded to the need private business and the government had for an active market for securities. Three events were important in promoting the activity of the securities market. The first was the decree of the Foreign Investment Law of 1973, which, as already mentioned, led foreign companies to sell their shares to investors in Mexico, including banks that acted as institutional investors. The second was the Law of 1975 itself, which encouraged new brokerages to promote initial public offerings among large companies. The third and most important was the expropriation of the banks in 1982, which led many large companies to resort to the stock market to obtain financing, as their banks had been separated from their business groups. Moreover, the expropriated banks used a significant part of their credit to finance the government. These three factors led to significant changes in the ownership and control structure of companies. Later, the regulation for issuing companies was modified, mainly in terms of disclosure of information and protection for shareholders (Cárdenas and Del Ángel, 2011).

4. GLOBALIZATION AND NEOLIBERAL REFORM

Beginning in the mid-1980s, Mexico began a major initiative to encourage international trade and market reform. First, there was an opening for portfolio investment and later the authorization of foreign direct investment. In 1993, a reform to the Foreign Investment Law adapted this legislation to the agreements established by the North America Free Trade Agreement (NAFTA). The corporate governance scenario changed significantly as a plethora of foreign companies began participating in the Mexican economy, either directly or in partnerships and ventures with Mexican companies and investors. Today integration into the global economy has led to large companies, in addition to being governed by Mexican laws, being regulated by corporate laws where the parent company resides, as well as international corporate law.

The regulation of the securities market also adapted to a new environment. Due to the increasing sophistication of the market and its transactions, most of the operations of the securities market were regulated by secondary rules that were easily changed when it was needed. The securities market law of 1975 was effective, with some modifications,

until 2006. Subsequent to 1975, it had two reforms, one in 2001 and another in June 2006. These reforms strengthened the regulation for brokerages, and sought to better protect the rights of minority shareholders (Caso Bercht, 1971, Cárdenas and Del Ángel, 2011).

As the number of firms participating in the securities market increased, concerns about corporate governance also grew, mainly over gaps in the mercantile law and how it addressed corporate practices. It should be noted that Mexican business has a concentrated structure and a relatively small number of families dominate several industries of the Mexican economy. Thus, many of the firms that were traded in the stock market belonged to close-knit cliques with kinship ties. There were also concerns over how firms implemented disclosure requirements and protection for minority shareholders. In that context, the Code of Best Corporate Practices (*Código de Mejores Prácticas Corporativas*) was issued in June 1999. This code contains principles of voluntary adherence for companies, and was issued by several private organizations and NGOs, led by the *Consejo Coordinador Empresarial*, the main association representing interests of the business community. Although in Mexico there had been local discussion on how to improve corporate governance practices, the Organization for Economic Cooperation and Development (OECD) 1999 'Principles for Corporate Governance' triggered stronger pressure for a code of good practice to be issued in the country: Mexico had joined the OECD in 1994 and adopting these standards became indispensable.

The Code is private and revisions have been made in 2006 and 2010. The Code's principles promote corporate practices that contribute to improving the integration and functioning of the board of directors and its supporting bodies. For example, its principles include equal treatment and protection of all shareholders, exercise of fiduciary responsibility by the board of directors, and prevention of illegal transactions and conflicts of interest. A particularity of the Mexican version of the Code is that its recommendations are directed at, and applicable to, all types of organizations, whether business or non-profit, without distinguishing by size or whether they are listed on the stock market (*Código de Mejores Prácticas Corporativas* 2010). Although adherence to the principles of the Code is voluntary, since January 2001, the financial supervision authority (*Comisión Nacional Bancaria y de Valores*) has required that all firms listed in the stock market disclose their compliance with the Code on an annual basis.

One of the most discussed aspects of the banking crisis that erupted in 1995 was the absence of an appropriate framework that provided both certainty and legal security when firms enter into a bankruptcy or liquidation process. The Bankruptcy and Suspension of Payments Law

(*Ley de Quiebras y Suspensión de Pagos*), legislation that had remained virtually untouched since 1943, was reviewed. A new Bankruptcy Law was promulgated in May 2000 and the previous law was repealed. The new law included measures to guarantee the legal security of creditors and borrowers, and aimed to simplify legal proceedings, in order to cut down the time spent on resolving bankruptcy cases. Legal reforms were also made to the provisions related to the guarantees system and the regulation of bankruptcy in April 2000. These reforms established two types of collateral mechanisms in the Banking Law: the guarantee trust (*Fideicomiso de Garantía*) and the Pledge without transfer of possession (*Prenda sin Desplazamiento de Posesión*) (Del Ángel, 2006).

CONCLUSIONS

The history of mercantile and corporate law in Mexico reflects a tension between the state's goals of controlling economic endeavours and promoting economic growth. On the one hand, it reflects the capacity of the state to devise and implement laws that promote economic activity. This capacity had been weak, and very difficult to strengthen, particularly regarding the implementation of the law. On the other hand, the evolution of the laws evidences different ideologies regarding the role of the state in the economy, and the role of foreign investment in contributing to economic development, that oscillate between liberal and nationalistic ideas.

In its evolution, Mexican mercantile and corporate law has been linked to cycles of globalization: from its beginnings, as part of the Spanish empire, to the contemporary integration of Mexico in the global economy and international trade agreements. Moreover, the shape of Mexican corporate laws followed international trends. For instance, during the 18th century the Mining Ordinances of 1783 had an unquestionable influence on other countries. But in other periods, for instance the 19th century, legal change was adapted with a delay compared to that of other Latin American nations.

The history of mercantile and corporate laws in Mexico contributes to a better understanding of the interactions among the state, legal expertise and actual business practices. However, we need more research to understand with more precision how these interactions took place, and how the law had the capacity to shape outcomes or was the consequence of negotiations among interest groups.

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17. A history of Canadian corporate law: a divergent path from the American model?

*Fenner L. Stewart**

INTRODUCTION

This chapter provides a brief history of Canada's corporate law. In part, it contemplates the judicial interpretations of the Canada Business Corporations Act (CBCA), and the controversies that arose from them. From this, it explains two claims that are often made about the CBCA. Some assert that it is more shareholder-centric than the American models, while others assert the opposite: that it is more stakeholder-centric. The chapter concludes that although both of these interpretations of the CBCA are reasonable from a gloss of the law, the reality of corporate governance in Canada is that managers, not shareholders nor stakeholders, have firm control over the corporation.

Part 1 begins with an explanation of Canada's first common law corporation. Part 2 traces the struggle to establish a single standard for incorporation (i.e., incorporation by registration). Part 3 describes the relatively slow rise of Canada's Modern Corporation as compared to the modern corporation's rapid ascent in the United States. Part 4 explains the rise of the Canadian Welfare State, while Part 5 makes clear how the Welfare State helped cement strong shareholder protections in the CBCA. Part 5 also details the period of the late 1960s to the mid-1970s, which marked the establishment of Canada's Modern Corporation. Part 6 traces the most controversial judicial interpretations of the CBCA's directorial provisions, as well as the most notable reactions to those interpretations. Finally, Part 7 offers some concluding thoughts about corporate governance in Canada today.

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1. CANADA'S FIRST COMMON LAW CORPORATION

In the 17th century, British ambition was to integrate the staples economies[1] of its territories in mainland North America[2] into its larger colonial system of trade (MacKintosh 1967). This global trade network included the formation of "corporations"[3] such as the Hudson's Bay Company[4] for British North America and the Royal African Company[5] for West Africa. They formed components of a "triangular trade" between

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[1] Although not uncontested, the "staples thesis" provides the most accepted narrative of the settler origins of Canada's cultural, political, and economic history. It argues that the building of Canada as a nation commenced through a slow westward expansion to exploit natural resource staples. For more see W.A. MacKintosh, *Economic Factors in Canadian History*, in W.T. Easterbrook and W.H. Watkins, eds., *Approaches to Canadian Economic History* (1967).

[2] By the 1780s, these territories, which are now present-day Canada, were informally being referred to as British North America. At the London Conference of 1866, delegates from British North America (i.e., the Province of Canada (now Quebec and Ontario), Nova Scotia and New Brunswick) met with officials from the British government to sign the *British North American Act, 1867* (U.K.), 30–31 Vict., c. 3. This signing lead to the formation of the Dominion of Canada on 1 July 1867. For more see Frederick Vaughan, *The Canadian Federalist Experiment: From Defiant Monarchy to Reluctant Republic* 80–86 (2003).

[3] Such corporations might have been called corporations, but they did not function like a modern corporation. It would be better to think of them as British Royal charters, which granted an exclusive right to exploit the riches of a particular territory of the British Empire.

[4] The Hudson's Bay Company was not the first corporation to operate in the land that would eventually become Canada, that honor belongs to the Compagnie de la Nouvelle France (the Company of New France, also known as the Company of One Hundred Associates). The latter corporation was a French trading company chartered in 1627 to expand the colony of New France and capitalize on its trade in furs. See W. J. Eccles, The Fur Trade and Eighteenth-Century Imperialism, 40 *William Mary Q*. 341 (1983).

[5] Pursuant to a charter granted by King Charles II, the Company of Royal Adventurers Trading to Africa was granted a monopoly over the mining and trading of gold and other precious minerals in West Africa. The company was eventually restructured and became the Royal African Company in 1672. Under a restructured charter, the company had powers to construct forts, raise and maintain an armed military force, and impose and enforce martial law in order to pursue trade in gold, silver, and slaves. For more information on the origins and purpose of the Royal African Company, see: Erika R. George, Incorporating Rights: Empire, Global enterprise, and Global Justice *10 U. St. Thomas L. J*. 917 at 938 (2012–2013).

England, Africa, the West Indies, and what would later become the U.S. and Canada.[6]

The Hudson's Bay Company was incorporated by Royal Charter on 2 May 1670. King Charles II granted the company an exclusive monopoly over an area that comprised approximately one-third of modern-day Canada as well as sections of present-day north-central U.S. The company was given the authority to enact any laws and regulations in this area that did not run contrary to the laws of England. The authority served the purpose of helping the company to maximize profits for its shareholders by "harvesting the natural resources of the empire" and of maintaining "the interests of the crown by carrying out exploration, territorial expansion and law making" (Smandych and Linden 1996).

The Hudson's Bay Company was superficially similar in some ways to a modern corporation. The company had stockholders and a centralized management like a board of directors, called the "Governor" and "The Committee," which managed the corporation in accordance with what was mandated in its Royal Charter (Royal Charter of the Hudson's Bay Company 1670). The corporation was also required to have yearly meetings, similar to a shareholder's meeting, in which the Governor held an annual General Court, and where the company's members could elect a new Governor (Royal Charter of the Hudson's Bay Company 1670). At such meetings, the company's members could also elect individuals to the Committee (Royal Charter of the Hudson's Bay Company 1670).

Although restrained by the English Parliament, the King or Queen exercised great power at the time through the Royal prerogative, which essentially acted as a set of privileges and immunities – power inherited through common law, ostensibly from Brutus of Troy, the first King of England (Keen 1973). A Royal Charter was an exercise of the Royal prerogative, delegating the Crown's power to those in the Sovereign's favor. In the Royal Charter of the Hudson's Bay Company, King Charles II declared the company to be a "Body Corporate and Politique" (Royal Charter of the Hudson's Bay Company 1670). Thus, the company, as a body of political nature, was a delegation of King Charles's authority (Hobbes 1651). Such companies were put in a position of significant power, acting as a monopoly for trade and control of a designated

[6] The triangular trade was comprised of economic activity between West Africa, Europe, and the Americas. Slaves were "exported" from the West Coast of Africa and traded in the Americas for "furs, tobacco, silver, sugar, molasses, hides, hard-woods etc., all of which fetched enormous profits in Europe." See U.O. Umozurike, The African Slave Trade and the Attitudes of International Law Towards It*, 16 Howard L.J.* 334 (1970–1971) at 337.

territory to further the interest of the King (i.e., the well-being of England). In other words, companies, like the Hudson's Bay Company, were public institutions, acting as the arms of the Sovereign within the colonial system of trade at the time (Hobbes 1651).

If those who were granted the privilege of incorporation fell out of favor with the Sovereign, such privilege could be revoked through the operation of one of two common law remedies: *quo warranto* (by what warrant?) or *scire facias* (make known) (Blackstone 1753, Bouvier 1839). In either case, the Sovereign could demand the authority from which one claimed his or her privilege and then scrutinize whether or not the one who produced such privilege (such as a Royal Charter) had lost it through neglect or abuse (Blackstone 1753). These common law remedies granted the Sovereign a powerful "royal weapon" to ensure loyalty and servitude; they were tools for the maintenance of feudal order (Bouvier 1839). As a result, nepotism was a key component of privilege, and loyalty was a key component of legal certainty. This historical fact rests in stark contrast to today's corporation, which is a private entity, and which is largely shielded from public interference in its business choices (Horwitz 1985).

The vestiges of incorporation through the Royal prerogative would persist long after responsible government in Canada came into effect (i.e., elected government, not appointed government, which was achieved in 1848). Such a form of incorporation was maintained through the mechanism of incorporation by letters patent, being simply another form of Royal prerogative exercised through the King's or Queen's representative in Canada (Currie 1962). However, when introduced to Canada in New Brunswick in 1862 and in Upper Canada (i.e., what would later become Ontario) in 1864, incorporation by letters patent was a step away from the trend of the Anglo-American model; by that time, both England and the U.S. were "almost exclusively" using the modern form of incorporation – incorporation by registration (Currie 1962). Today, the letters patent system of incorporation still exists, at least in name, in one province: Prince Edward Island.[7]

[7] *Companies Act R.S.P.E.I.* 1988, Cap. C-14, s. 4. The Minister may, by letters patent, grant a charter to one or more persons who apply therefore, constituting that person and others who may become shareholders in the company hereby created, a body corporate and politic for any purposes or objects to which the legislative authority of the Legislature extends, except trust companies and insurance companies.

2. THE HISTORY OF GENERAL INCORPORATION STATUTES IN CANADA

Before Canadian Confederation in 1867, the provinces and territories had no general incorporation statutes – no legislation allowing corporations to be formed by a simple registration process – with the exception of the Province of Canada, which passed two such statutes in 1849: one for Upper Canada[8] and one for Lower Canada (i.e., what would later become Quebec).[9] Without a general incorporation statute, there were two methods by which incorporation could occur within pre-Confederation Canada: a Royal Charter or an act of legislature (Ziegel et al. 1994). In 1860, the Province of Canada also created a third option of incorporation by judicial decree (Currie 1962).

Under each of these forms of incorporation, an incorporator would have to come cap-in-hand and petition for the privilege of forming a corporation. Then, the Crown-appointed governors (if by Royal Charter), the elected representatives (if by an act of legislature), or judges (if through incorporation by judicial decree) would decide if it was in the public interest to grant such a privilege. During the first half of the 19th century, it was generally accepted that incorporation was a privilege granted to further the public interest; even in the U.S., it was accepted that such a privilege was "an emanation of the state, created by revocable grant."[10]

The advent of general incorporation statutes in the 19th century led to a radical shift in corporate theory in the 20th century. Under a general incorporation statute, an incorporator files an application with the designated administrative office and pays a fee. As long as the registration procedure is followed, the incorporator is entitled to receive a corporation. With this shift in process, incorporation was transformed from a privilege to a right, and the corporation, over time, transformed from a public organization to a private one (Sciulli 1999, Horwitz 1985).

The concession theory of the corporation accurately describes the 19th century corporation; it asserts that the corporation is a legal fiction created by a revocable grant of the state (Indeterminacy and Balance 2012). Following the logic of the Royal prerogative, incorporation is a

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[8] *Joint Stock Companies in Upper Canada to construct Macadamized roads and other works*, 12 Vic., c. 84 (1849).

[9] *Joint Stock Companies in Lower Canada to construct Macadamized roads and bridges*, 12 Vic., c. 56 (1849).

[10] *Dartmouth College* v. *Woodward*, 17 U.S. 518 (1819), 636.

privilege granted to further public interest and, if neglected or abused, should be revoked. Today, those that manage corporations do not fear public power through revocation, but fear private power through bankruptcy or removal by shareholders (Indeterminacy and Balance 2012). Today, the nexus-of-contracts theory, for better or worse, dictates how the Anglo-American corporation is viewed and operated (Indeterminacy and Balance 2012). The contractarian Stephen Bainbridge states:

> It has been over half-a-century since corporate legal theory, of any political or economic stripe, took the concession theory seriously. In particular, concession theory is plainly inconsistent with the contractarian model of the firm, which treats corporate law as nothing more than a set of standard form contract terms provided by the state to facilitate private ordering. The state provides the corporate form not so the corporation can ensure social welfare, but solely as a means of facilitating private ordering amongst people (Bainbridge 2010).

Accordingly, the advent of general incorporation statutes had a greater significance than those at the time probably appreciated. Such lawmakers were merely attempting to find a way to streamline the incorporation process (Currie 1962), and not engage in an ideological campaign to reform corporate function.

The 1849 general incorporation statutes for Upper Canada and Lower Canada narrowly authorized the incorporation of joint-stock companies for the construction of roads and bridges (Ziegel et al. 1994). New York had started legislating such general incorporation law in 1811, and the Province of Canada leaned on New York's experience, basing their 1849 incorporation statutes upon New York's 1948 version (Seavoy 1972, Risk 1973, Ziegel et al. 1994). Starting the next year and continuing until Confederation in 1867, the Province of Canada passed more of these general incorporation statutes allowing business to incorporate by registration in other targeted areas of business activities (Risk 1973). These targeted business activities tended to advance the public interest, including: manufacturing; mining; banking; building canals and railways; and supplying gas, light, and water services (Risk 1973).

General incorporation statutes from the middle of the 19th century, such as New York's and Canada's, did not grant the array of rights that incorporators enjoy today (Sciulli 1999). Restrictions on corporations "were severe" as compared to today: there were limits on capital accumulation; the duration of the corporation was fixed to the designated tasks for which it was incorporated; corporate activities were restricted to the activities listed in the incorporation documents; and its business

activities were limited to the jurisdiction in which it was incorporated (Corporate Law-Making 2011).

Moving away from what would become the modern form of incorporation (i.e., the incorporation by registration), the Province of Canada enacted an alternative method in 1864; this method was by letters patent issued under seal of the Governor in Council, mirroring the process of the incorporation by Royal prerogative.[11] This choice was criticized by some observers at the time, because the form selected for incorporation could affect the legal nature of the corporation (Mulvey 1920). Corporations created by letters patent, an act of legislature, a judicial decree or registration were not necessarily the same – distinctions existed (Mulvey 1920). It was feared that by encouraging a variety of Canadian corporations, it would encourage needless complexity within Canadian corporate law, making it more difficult to assess which legal precedents applied to what corporations (Mulvey 1920). Moreover, the letters patent approach was adopted later by the Dominion of Canada (i.e., the newly created Federal Government) in the *Canada Joint Stock Companies Letters Patent Act, 1869*.[12] This choice represented an arguable misstep, moving away from what history would later establish as the modern process of incorporation.

This failure of foresight was amplified by the fact that some provinces subsequently followed, or felt more justified in continuing to use, this approach to incorporation (Mulvey 1920). As a result, a larger split in methods of incorporation between jurisdictions emerged, having the unintended consequence of a formal, and yet largely functionally insignificant, difference between the provincial corporate laws of Canada; this added needless judicial complexity when determining whether or not a precedent for one type of corporation could apply to another (Ziegel et al. 1994).

Meanwhile in the U.S., the second half of the 19th century up to 1932 (i.e., the year in which the *Modern Corporation and Private Property* was published) harkened a period of legal transformation and economic progress that ended with the birth of America's modern corporation (Delaware Primacy 2011, Shareholder Primacy 2011). It could be argued that the series of reforms that led to the American modern corporation, in 1846, started when New York set a strong standard for incorporation by registration by blocking the legislature from creating corporations by special act, except in cases where the objectives for devising the

[11] *General Act*, 27 & 28 Vic, c.23 (1864).
[12] *Canada Joint Stock Companies Letters Patent Act*, SC 1869, c. 13.

corporation was not attainable under general law.[13] This standard for incorporation by registration would be adopted later by other states (Delaware Primacy 2011).

By comparison, nearly 75 years after New York set the standard for incorporation by registration, Canada was still struggling with this seemingly basic issue of how corporations ought to be incorporated. In 1920, the drafter of Canada's most significant corporate law at the time (Murphy 1984, Murphy 1986), Thomas Mulvey, was dismayed by the needless lack of progress in the advancement of Canadian corporate law (Mulvey 1920). When observing the incorporation standards between Canadian jurisdictions, Mulvey wrote with patience and frustration:

> These methods [of incorporation] are essentially different in principle, and these differences and their conclusions pervade the details of company organization. Which method should prevail is the subject for discussion. Each has its advantages, and perhaps its disadvantages, but it appears to be in the interest of everyone concerned that a uniform method should be adopted, and in the end very little inconvenience would follow the adoption of either method (Mulvey 1920).

Mulvey's plea would be ignored, and it would not be until the 1970s that a strong standardizing model for Canadian corporate law would emerge (Ziegel et al. 1994).[14]

The resulting lack of uniformity of incorporation procedures stunted the evolution of the Canadian corporation by distracting jurists, judges, regulators, and lawyers with issues of needless complexity (Mulvey 1920). While America enjoyed the rise of its modern corporation, Canadian corporate law stagnated. In fact, from the second half of the 19th century up to the 1970s the evolution of the Canadian corporation has been characterized by prominent Canadian corporate law scholars as "largely consist[ing] of fleshing out" the anachronistic features of 19th century legislation. Accordingly, not much legal imagination was being directed to what sort of business organization would help carry the Canadian economy through the 20th century (Ziegel et al. 1994).

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[13] N.Y. CONST. OF 1846, art. VIII, § 1.

[14] *Ontario Business Corporations Act*, RSO 1970, c. 53, and *Canada Business Corporation Act*, SC 1974, c. 33. Both were inspired largely by the Model Business Corporation Act, which was drafted by a Committee of the American Bar Association and the legislation of New York, California, and Delaware.

3. CANADA'S SLOW PROGRESS TO THE MODERN CORPORATION

The Canadian progress toward the birth of its own modern corporation was slow and usually followed the U.S. lead. This fact might come as a surprise to some contemporary Canadian corporate observers, who might assume it largely followed the British lead, as in other areas of law. However, this presumption is false. As Mulvey explains, although it was true that "the courts were always under the influence of the English decisions," Canadian legislatures usually "obtained their inspiration from the United States" when drafting business law (Mulvey 1918).

In 1867, the U.S. Congress expanded bankruptcy protections to include corporations (Sciulli 1999). Canada followed in 1875 by expanding similar protections to include the involuntary bankruptcy of trading companies, but excluded banks, insurance companies, telegraph companies, and railway companies.[15] Then in 1919, *The Bankruptcy Act of 1919* modernized Canada's bankruptcy protections to meet a standard more akin to that of the U.S.[16]

In 1886, the U.S. Supreme Court declared the corporation a "natural person" and found that the equal protection clause of the Fourteenth Amendment applied to the corporation, granting it significant protections from public authority.[17] Following suit, a somewhat similar understanding of corporate personhood was introduced to Canadian law in 1897.[18] That said, time would tell that Canadian law would not accommodate the same constitutional protections for such personhood.[19]

Like in the United States at the end of the 19th century, Canadian law also provided few protections for shareholders (Berle 1926, Naylor 2006). The *Canada Joint Stock Companies Act, 1887* required "directors

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[15] *An Act Respecting Insolvency*, 38 Vict., SC 1875, c. 16.

[16] *The Bankruptcy Act of 1919*, 9 & 10 Geo. V, SC 1919, c. 36.

[17] *Santa Clara County* v. *Southern Pac. R.R.*, 118 U.S. 394 (1886). For a detailed understanding of the case and a detailed argument regarding the fallout from this case in America, see Morton J. Horwitz, Santa Clara Revisited: The Developments of Corporate Theory, 88 *W. VA. L. Rev*. 173 (1985).

[18] *Salomon* v. *Salomon & Co*., [1897] A.C. 22.

[19] A decision, like *Citizen United* v. *Federal Election Commission*, No. 08-205, 558 U.S. 310 (2010), would not be likely in Canada, since there are differences. Although personhood is acknowledged, it is only one consideration to be balanced against other negative effects of potentially taking such a legal fiction too far. For instance, consider *Big Bend Hotel Ltd.* v. *Security Mutual Casualty Company*, 1980 CanLII 505.

of every company to lay before its shareholders a full and clear printed statement of the affairs and financial position of the company at or before each general meeting," but there was no requirement as to how frequently such meetings were to be held.[20] Closing this gap, the *Canada Joint Stock Companies Act, 1902* required that such general meetings be held annually.[21] Then, in 1907, Canadian legislation took the lead as a legal innovator, stepping forward well ahead of the U.S. and Britain on the issue of corporate disclosures (Murphy 1986). The *Ontario Companies Act, 1907* required certain documents to be presented at an annual general meeting:[22]

(a) a balance sheet made up to a date not more than three months before such annual meeting;
(b) a statement of income and expenditure for the financial period ending upon the date of such balance sheet;
(c) the report of the auditor or auditors;
(d) such further information respecting the company's financial position as the letters patent or the by-laws of the company may require …

These disclosure rules, which were largely penned by Mulvey, were described as "the most path-breaking piece of corporate disclosure legislation in Canadian history," and the one moment in the early history of Canadian corporate law that set an example for the United States and Britain (Murphy 1984, Murphy 1986).

In 1904, Mulvey was appointed as an assistant provincial secretary in Ontario (Murphy 1986). Mulvey, despite being much different, shared some parallels with Adolf A. Berle, who was a strong advocate for shareholder rights and was very concerned that a lack of legal accountability to shareholders could lead to market instability (Shareholder Primacy 2011). In 1909, Mulvey took a position with the Federal Government, being appointed Under-Secretary of State (Hilliker 1990). This position was the assistant to the Secretary of State, whose role was to provide an official channel of communication between the Dominion of Canada and the imperial government in London (Hilliker 1990). In 1917, *The Companies Act Amendment Act, 1917* largely mirrored the

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[20] *Canada Joint Stock Companies Act, 1877*, 40 Vic. ch. 43, sec. 87.
[21] *Canada Joint Stock Companies Act, 1902*, 2 Edward VII, ch. 15, sec. 88.
[22] *Ontario Companies Act, 1907*, 7 Edward Vll. ch. 34, sec. 36.

disclosure requirements of the *Ontario Companies Act, 1907*, but operated at the Federal level.[23] Mulvey played a key role in having these disclosure standards adopted by the Federal statute (Murphy 1984). But, in 1916, Mulvey was still disappointed with the pace of progress, expressing dissatisfaction with the impact of legislative efforts:

> The loss to the public through fraudulent promotions and reckless management of companies is constantly before it. There is a constant cry for protection by legislation. For this purpose many ineffective remedies have been suggested and adopted in Canada as well as in the United States. The expected result has not been attained, and the demand for further legislation of the same class with more stringent provisions is called for (Mulvey 1916).

In 1910, the U.S. Supreme Court nullified restrictions on corporate capacity to conduct business outside the state in which it was chartered (Millon 1990). Likewise, Canada resolved this issue in 1916.[24] However, Canada had additional constitutional issues in this area, since both the Federal and provincial governments had authority to incorporate companies.[25] Predictably, this overlapping authority created a tension between the provinces and the Federal Government as to the scope of provincial authority over Federal corporations. This issue was largely resolved in 1914, when it was determined that provinces could not require Federal corporations to be registered locally to carry on business.[26]

In 1920, Mulvey spoke to the lack of legal certainty in Canadian corporate law:

> At the present time more than any other during the history of Canada, the greater freedom of business method is necessary. When a lawyer cannot advise his client with respect to the capacity of a proposed company or with respect to the limitations under which it may be placed, business development must be hampered. … The time for quibbling is past. The working out of logical conclusions of theoretical principles which were sufficient for past times will not avail us at present. Company law is for the business community and the advancement of trade. Company law should not be for the sophist or the quibbler. The question of the method of solving these difficulties remains (Mulvey 1920).

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[23] *The Companies Act Amendment Act, 1917*, 8 George V, ch. 25. sec. 105.

[24] *Bonanza Creek Gold Mining Co. Ltd.* v *The King* [1916] UKPC 11, [1916] 1 AC 566 (1916).

[25] *Citizens Insurance Co.* v. *Parsons*, [1881] UKPC 49, [1881] 7 A.C. 96 (1881).

[26] *John Deere Plow Co. Ltd.* v. *Wharton* [1914] UKPC 27, [1915] AC 330 (1914).

And yet, despite Thomas Mulvey's best efforts,[27] Canada's corporate legal regimes would be untangling themselves from 19th century legislation for more than half of the 20th century (Ziegel et al. 1994).

That said, the first half of the 20th century was a time of radical changes, both economic and cultural, for the young country of Canada – corporate law did not appear to be its top priority (Holdsworth and Kerr 2000).

4. SOME SOCIO-ECONOMIC DETERMINANTS IN THE RISE OF CANADA AS A MODERN STATE

During the first third of the 20th century, Canada's autonomy expanded and it became more prominent, both politically and economically (Busch 2014). In particular, Canada's efforts during the Great War granted Canada a *de facto* sovereignty from Britain, a status that would be cemented in law with the enactment of the *Statute of Westminster, 1931* (Busch 2014).[28]

The Great Depression would mark a dramatic, and unexpected, shift in the winds of Canada's political economy. By 1932, Canadian industrial production fell to 58 percent of the pre-crash levels of 1929, while national income levels dropped correlatively, falling by 32 percent (Bryce 1986). It was estimated by the International Labour Office that unemployment rates in Canada were four times higher in 1932 than in 1929 (Bryce 1986). The effects in the U.S. were similar; in response, Franklin D. Roosevelt implemented the New Deal, a series of federally backed economic recovery programs (Marcuss and Kane 2007, Field 2009, Harkrider 2009). Canada did not follow his lead, and no similar national recovery program was implemented (Wardhaugh 2000).

R.B. Bennett (Conservative Party of Canada) had been Prime Minister since 1930, and it was not until the final hours of his 1935 campaign that a national recovery program seemed possible, when he promised his own New Deal (McConnell 1968). But when Mackenzie King (Liberal Party

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[27] As mentioned, Mulvey was the "chief architect" of one of Canada's most progressive and influential pieces of corporate legislation in the history of Canadian corporate law, see George J. Murphy, Early Canadian Financial Statement Disclosure Legislation, 11 *The Accounting Historians Journal* 40 (1984). He was also a vocal critic of Canada's lack of initiative in reforming Canadian corporate law further, see Thomas Mulvey, Some Phases of Canadian Company Law, 20 *Can. L Times* 832, 845 (1920).

[28] *Statute of Westminster, 1931*, 22 & 23 Geo. 5 c. 4.

of Canada) came to power later that year, such a program was no longer on offer (Blake 2009). Observers have noted that this bipartisan inaction encouraged Canadian socialism, supporting the rise of the Cooperative Commonwealth Federation (CCF) (Wiseman 2014).

As in the U.S., the Second World War ended the Great Depression (Vernon 1994). In 1942, the Federal Government took control of the Canadian economy to ensure the efficiency of wartime production; its control was “comprehensive, centralized, coercive, and compulsory” (Stevenson 2001). After the war, the Federal Government retrenched, and left much of the economy to operate in the free market (Holdsworth and Kerr 2000).

At this time, socialist theory was sweeping across most of the West, influencing many post-war countries to adopt mixed-market economies, and ultimately leading to the rise of welfare states (Jones 1958). Canada was not an exception to this trend and opinion polls initially indicated a dramatic surge in support for the CCF before the 1945 Federal election (Wardhaugh 2000). Like Churchill, King had won the war, was still Prime Minister, and disagreed with much of welfare state ideology while in office (Rasor 2000). But unlike Churchill, he did not lose an election immediately after the War.

In a deft political move in 1944, King created the family allowance (i.e., a monthly government payment to families with children to help cover child costs), which was just enough to undermine the CCF’s campaign (Blake 2009, Levine 2011). Before the election, his cabinet would pledge itself to social assistance, health insurance, old age pensions, and standardized prices for farm staples (Wardhaugh 2000). Although King is attributed with helping to develop the welfare state through his development and implementation of various social policies, it would not be until his retirement in 1948 that the Canadian Welfare State truly emerged, reaching its peak in 1966 with the social programs introduced by Lester P. Pearson (Wardaugh 2000, Kent 2014).

The rise of the Canadian Welfare State was underpinned by a massive institutional reorganization (Wardhaugh 2000). In the 1960s, resource exploitation remained the economy’s main driver; however its scope and breath, as well as the institutional complexity that framed it, had grown exponentially (Holdsworth and Kerr 2000). Yet, amid all this change from the 1890s into the 1960s, “there were few basic conceptual changes” in Canada’s corporate statutes (Ziegel et al. 1994).

However, this was about to change. In 1965, the Ontario government created the Attorney-General’s Committee on Securities Legislation and in 1967, the Federal Government established a committee to produce a report that would detail the current state of federal corporation law, and

then recommend reforms (Feltham and Rauenbusch 1975, Hay 1984). The result would be the birth of Canada's modern corporation, and would mark "the most important and widespread wave of reform in Canadian corporate history" (Welling 2006).

As will be explained in the next section, since a robust welfare state existed at the time that these corporate law reforms were made, it had a profound effect on the recommendations made by both the Ontario and federal corporate reform committees (Lawrence et al. 1967, Dickerson et al. 1971). The regulatory architecture of Canada's Welfare State in the 1960s and 1970s provided a wide array of regulatory protections for labour, consumers, and other constituents of the corporation. As a result, little pressure was placed upon the reform committees, and the subsequent legislators, to protect stakeholder (i.e., non-shareholder) interests within corporate law, leading to what Brunner observes to be more shareholder-centric corporate statutes in comparison to what exists in the U.S. (Bruner 2013).

5. THE BIRTH OF CANADA'S MODERN CORPORATION

Welling observes that it "seems surprising now that so little Canadian-based development of corporate law took place during the 100 year period" which preceded corporate reforms made by Ontario and the Federal Government in the late 1960s and early 1970s (Welling 2006).

In 1963, J.R. Kimber started this reform movement in earnest, when he was appointed Chairman of the Ontario Securities Commission (Baillie 1965). He immediately recommended to Ontario's Attorney General that a committee needed to be created to offer reforms to modernize Ontario's securities law regime (Baillie 1965). Mulvey, as an early Canadian advocate for greater shareholder protection, would have been pleased with Kimber's subsequent report in 1965 (Kimber et al. 1965). The Kimber Report, formally called the *Report of the Attorney General's Committee on Securities Legislation in Ontario*, was heavily influenced by American precedents, and resulted in much stronger protections for shareholders (Beck et al. 1983, Kimber et al. 1965). The following year, Ontario passed the *Securities Act, 1966*,[29] which amended the existing regulations to accommodate the Kimber Report's recommended shareholder protections (Kimber et al. 1965).

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[29] *Securities Act, 1966*, SO 1966, c. 142.

In 1965, the Ontario Legislative Assembly appointed Allan F. Lawrence to chair a committee to review and reform Ontario's corporate law regime, resulting in the *Interim Report of the Select Committee on Company Law* (also call the Lawrence Report) (Lawrence et al. 1967). The Lawrence Report, issued in 1967, directly acknowledged the significant influence of American law in its recommendations, stating "no materials received closer examination and consideration than the federal and state laws of the United States" (Lawrence et al. 1967). Ziegel et al. were more specific, pinpointing that the report was heavily influenced by the Model Business Corporations Act drafted by the American Bar Association as well as a few leading American state-level legislative precedents, which included corporate statutes from Delaware, New York, and California (Ziegel et al. 1994). In other writings, Ziegel emphasized that British precedent had only minor influence (Ziegel 1973). In 1970, Ontario passed the *Ontario Business Corporations Act*,[30] which "largely implemented" the Lawrence Report's recommendations (Ziegel et al. 1994).

The Lawrence Report's recommendations were an aggregate of American corporate laws at the time, except for one significant difference. The report recommended much stronger protections for shareholders than American corporate law regimes at the time, or today (Lawrence et al. 1967, Bebchuk 2005, Bainbridge 2006, Bebchuk 2006). For instance, it asserted:

> [T]here appears to be no logical reason why the Act should not authorize the shareholders to remove directors during their term of office. Nor is there any persuasive reason why removal should require a vote in excess of the majority of the votes cast at the meeting duly called for the purpose (Lawrence et al. 1967).

When this is coupled with the report's recommendation that only 5 percent of shareholders ought to be needed to call a shareholders' meeting (Lawrence et al. 1967), one can appreciate why shareholder advocates celebrated when the report was released (Bruner 2013).

In 1970, the *Ontario Business Corporations Act* (OBCA) adopted all of the report's recommendations.[31] It would also finally replace incorporation by letters patent[32] with incorporation by registration.[33] The Act also

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[30] *The Business Corporations Act*, SO 1970, c. 53.
[31] *The Business Corporations Act*, SO 1970, c 53.
[32] *Corporations Act*, RSO 1960, c 71, s 3(1).
[33] *The Business Corporations Act*, SO 1970, c 53, s 4(1).

introduced other reforms, which included: clarifying the standards for pre-incorporation contracts;[34] dealing with the antiquated problems with *ultra vires* that still persisted;[35] allowing for one-person corporations;[36] codifying some of the duties of directors and officers;[37] dealing with insider trading;[38] and granting the right for shareholders to bring derivative actions.[39]

In 1967, following Ontario's lead, the Federal Government appointed Robert W.V. Dickerson to chair a committee to review and reform federal corporate law, resulting in the *Proposals for a New Business Corporations Law for Canada* (also call the Dickerson Report) (Dickerson et al. 1971). The Dickerson Report, issued in 1971, provided one volume of commentary and a second that offered an annotated draft statute (Dickerson et al. 1971). Prominent Canadian corporate scholars would comment on the fact that Dickerson's draft act, "to a remarkable extent … mirrored changes and concepts that had already been adopted in the Ontario Act" (Ziegel et al. 1994). The one notable difference between Dickerson's draft act and the OBCA was the inclusion of the oppression remedy, which offered broad and flexible protection of minority rights, based on section 210 of the *English Companies Act, 1948* (Dickerson et al. 1971).[40]

In 1975, the Federal Government enacted the *Canada Business Corporation Act* (CBCA), which adopted Dickerson's draft act with only "minor changes" (Ziegel et al. 1994). The CBCA would set the standard for corporate law in Canada, and is still the prevailing approach to regulating almost all Canadian corporations today (Bone 2011). The only

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[34] Ibid., s 20(1)–(4)
[35] Ibid., s 16(1)–(2).
[36] Ibid., s 4(1).
[37] Ibid., ss 123(2), 134(5).
[38] Ibid., s 150(1).
[39] Ibid., s 99(1).
[40] *Companies Act, 1948*, 11 & 12 GEO. 6. ch 38, s 210.

> (1) Any member of a company who complains that the affairs of the company are being conducted in a manner oppressive to some part the members (including himself) … may make an application to the court … If on any such petition the court is of opinion –
>
> (a) that the company's affairs are being conducted as aforesaid; and
> (b) that to wind up the company would unfairly prejudice that part of the members …
>
> the court may, with a view to bringing to an end the matters complained of, make such order as it thinks fit …

notable amendments were made in 2001 (House of Commons 2010). These amendments further enhanced shareholder rights, and marked an abandonment of a Federal presence in Canadian securities laws, making the CBCA a more "pure" corporate statute (Gray 2003).

Canadian corporate scholars have offered insight into why Canadian corporate legislation has evolved in a manner that is so heavily influenced by American law:

> Probably the most important reason is Canada's close business connections with the U.S., and the fact that our corporate practices and philosophies have been much influenced by intensive exposure to those of our powerful neighbor. A second reason is that the U.K. has been significantly slower to abandon 19th century concepts than North American jurisdictions, thus making the *British Companies Act* a much less interesting source of innovative solutions … . (Beck et al. 1983).

Although the CBCA has been heavily influenced by American precedents, it still has a number of significant differences, including: greater shareholder empowerment[41] and a broad judicial power to protect minority rights of "complainants",[42] a category which is defined broadly by the CBCA to include both shareholders and other stakeholders of the corporation.[43]

Bruner illustrates how the Dickerson Report strongly endorsed a shareholder-centric approach to corporate power, suggesting that there might be an underlying rationality similar to that of what "Easterbrook and Fischel would later advocate" (Bruner 2013). To explain, Easterbrook and Fischel argued that corporate law ought to "allow managers and investors to write their own tickets, to establish systems of governance without substantive scrutiny from a regulator" (Easterbrook and Fischel 1991). Furthermore, they argued that if employers, consumers, creditors, and other stakeholders cannot protect themselves through market mechanisms (i.e., contracts), other areas of law – not corporate law – need to intervene, ensuring corporate law remains focused upon profit maximization (Easterbrook and Fischel 1991). Brunner suggests that Easterbrook and Fischel's keep-corporate-law-out-of-it approach did not threaten Canadians as much as Americans, because in the 1960s Canadians felt well protected by a robust welfare state. Meanwhile Americans,

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[41] Including: (1) *Canada Business Corporations Act* [hereinafter *CBCA*], RSC 1985, c C-44, s 109(1); (2) ibid., s107(g); (3) ibid., s 143(1); (4) ibid., s 146(1).

[42] Ibid., s 241.

[43] Ibid., s 238(a)–(d).

who did not enjoy the same level of socio-economic protections, must have felt more exposed to market discipline, and thus demanded more protection under corporate law (Bruner 2013).

Whether Bruner's claim is true or not is difficult to establish clearly from the Dickerson Report. But after the Dickerson Report was released, prominent Canadian commentators construed it as an endorsement of the law and economics approach, which would become the foundation for Easterbrook and Fischel's work (Bruner 2013, Iacobucci et al. 1977). What Bruner does with this insight, if correct, helps the reader understand why the history of the Canadian Welfare State is important to understanding the evolution of Canadian business law:

> [T]he lack of concerted opposition to shareholder-centric corporate governance rules (including by organized labor) – particularly in light of the substantial completion of Canada's welfare state by the time significant corporate law reform efforts arose – provide at least indirect evidence that Canadian policy makers were generally comfortable with the capacity of extra-corporate regulation to safeguard the interest of non-shareholders, including employees. Put differently, the Dickerson Committee's conclusion that non-shareholders are best protected outside corporate law did not precipitate protests, or even substantial comment, for the same reason the equivalent position provoked neither protest nor substantial comment in the United Kingdom – extra-corporate stakeholder protections had, in fact, deflected social and political pressure for corporate law to demonstrate such regard for non-shareholders' interests (Bruner 2013).

Ergo, strong shareholder-centric reforms did not generate the level of contestation and debate that they did in the U.S. So, the Canadian Modern Corporation ended up with stronger shareholder protections, because the welfare state made Canadians feel protected. Of course, some might sardonically suggest that adopting the British Oppression Remedy in the CBCA helped too.[44] But, Bruner's theory still holds water, since the CBCA's forerunner, the OBCA, did not have such an Oppression Remedy provision, and also did not experience serious contestation and debate (Bruner 2013).

That said, not all Canadian corporate law observers would agree that the Canadian corporate governance model is more shareholder-centric in comparison to American corporate law; some argue that it is actually more stakeholder-centric. Both of these arguments tend to suggest that Canadian corporate law must at least be less director-centric, but readers

[44] Ibid., s 241.

ought to consider how Canada's modern corporation weathered its adolescence before drawing any conclusions.

6. THE GROWING PAINS OF CANADA'S MODERN CORPORATION

All but two of Canada's common law provinces have adopted a business corporation act that is similar to, if not a reproduction of, the CBCA.[45] Even Quebec, which is a civil law jurisdiction, has a business corporations act that is much like the CBCA.[46] Nova Scotia[47] and Prince Edward Island[48] are the only outliers. However, the uniqueness of their corporate law, and the nature of their small economies, help to minimize the impact they have upon the convergence of Canadian corporate law to the CBCA model.[49]

If one looks to only a select number of provisions from the CBCA, an argument can be made that Canadian corporate law appears to provide greater shareholder empowerment than does the American model.[50] To build this argument, one points to the fact that shareholders have the immutable right to remove directors without cause[51] and without regard to their term.[52] Thus, staggered boards, which securely entrench director power in the U.S., offer Canadian directors little protection (Bebchuk et al. 2002, Bebchuk and Cohen 2005, Guo et al. 2008, Cohen and Wang 2013). In addition, 5 percent of shareholders can force management to

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[45] Of note, in comparison to the other provinces that have converged upon the CBCA model, British Columbia's Business Corporations Act is less like, but still very similar to, the CBCA. It has a different incorporation process, and some minor differences like the fact that unanimous shareholder agreements are not codified. See *Business Corporations Act*, SBC 2002, c 57, s 10(3)(e).

[46] *Business Corporations Act*, CQLR c S-31.1

[47] *Companies Act*, RSNS 1989, c 81.

[48] *Companies Act*, RSPEI 1988, c C-14.

[49] The most recent figures from Statistics Canada reflect that these two provinces have minimal economic activity, combining for 2.28 per cent of Canada's Total Gross Domestic Product in 2014. See Statistics Canada, *Gross domestic product, expenditure-based, by province and territory*, http://www.statcan.gc.ca/tables-tableaux/sum-som/l01/cst01/econ15-eng.htm.

[50] Including: (1) *CBCA*, RSC 1985, c C-44, s 109(1); (2) ibid., s 107(g); (3) ibid., s 143(1); (4) ibid., s 146(1).

[51] Ibid., s 107(g).

[52] Ibid., s 109(1).

call a shareholders meeting,[53] and it takes a bare majority of shareholders to remove a director.[54] Moreover, shareholders – but not the company – can use public communication, such as press releases and website posts, to communicate a proxy circular.[55] Finally, shareholders have the codified right to seize managerial power directly through the use of unanimous shareholder agreements.[56] These examples might shock American readers, leading them to the conclusion that Canadian corporate law is more shareholder-centric than theirs.

However, a strong stakeholder-centric argument also can be made when one selects a different set of provisions from the CBCA. For instance, section 241 of the CBCA, the Canadian Oppression Remedy, allows for shareholders, and also a range of other stakeholders (i.e., complainants),[57] to bring personal actions against the corporation.[58] To win a claim, a complainant must prove its reasonable expectation has been violated by the closely-held – or public – corporation,[59] and that the corporate conduct, which undermined such expectation, falls within what has been thus far the ill-defined terms of "oppression", "unfair prejudice" or "unfair disregard."[60] As per remedies, if a court finds that such corporate conduct has run afoul with the Oppression Remedy, then the CBCA grants it the power to "make any interim or final order it thinks fit."[61]

Adding to the stakeholder-centric argument is the Supreme Court of Canada's interpretation of section 122(1)(a) from the CBCA, which states:[62] "every director and officer of a corporation in exercising their

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[53] Ibid., s 143(1).

[54] Ibid., s 107(g).

[55] Ibid., s 150(1.2).

[56] Ibid., s 146(1).

[57] In fact, the court can deem any person "who, in the discretion of a court, is a proper person to make an application under [the oppression remedy]": see *CBCA*, RSC 1985, c C-44, s 238(d). Few limitations have been definitely carved from this discretion. The most notable is that the complainant is barred from making a claim if the corporation is the person harmed and not the individual complainant. In such cases, the appropriate action is a derivative action and not the oppression remedy. See Jeffrey MacIntosh, The Oppression Remedy: Personal or Derivative, 70 *Can. Bar Rev.* 29, 30–31 (1991).

[58] *CBCA*, RSC 1985, c C-44, s 241(1).

[59] Ibid., s 241(2).

[60] *BCE Inc. v. 1976 Debentureholders*, 2008 SCC 69, [2008] 3 SCR 560 at para 54.

[61] *CBCA*, RSC 1985, c. C-44, s 241(3).

[62] Ibid., s 122(1)(a).

powers and discharging their duties shall act honestly and in good faith with a view to the best interests of the corporation."

In 2004, when the Supreme Court ruled on the *Peoples* case, it interpreted this provision as follows:[63]

> [I]n determining whether [directors] are acting with a view to the best interests of the corporation it may be legitimate, given all the circumstances of a given case, for the board of directors to consider, *inter alia*, the interests of shareholders, employees, suppliers, creditors, consumers, governments and the environment.

This decision shocked Canadian corporate law observers, since it was inconceivable that the Dickerson Committee, which drafted this language, would have agreed with this interpretation.

In 2005, Ziegel, a prominent Canadian corporate legal scholar at the time the CBCA was drafted, became a vocal opponent of the *Peoples* case, arguing that the Supreme Court "overlooked" precedent, and that the result would push Canadian corporations into "the quagmire of having to serve multiple masters" (Ziegel 2005). He concluded that the judgment was an "aberration from the court's usual demanding standards of analysis and attention to precedent" (Ziegel 2005).

Other Canadian scholars were less critical, but also less prominent, than Ziegel. For instance, Lee had "considerable sympathy" for the court's choice to expand corporate law to protect stakeholders, but found it "disappointing" to observe the "court's evasion of the underlying normative issues" (Lee 2005). Rousseau worried *Peoples* "could lead to a greater liability risk for directors" and "a greater role for the judiciary in corporate governance" (Rousseau 2005). Francis predicted that the decision likely would "be significant and far-reaching", warning of the "peril" of "ignor[ing] the interests of significant stakeholders" (Francis 2005). Finally, MacPherson observed that the decisions presented "more questions" than "answers", adding "we can only hope that answers will come sooner, rather than later" (MacPherson 2005).

A reply did come sooner. In 2008, the Supreme Court of Canada released its judgment in the *BCE* case.[64] The court once again revisited the meaning of the "best interests of the corporation":[65]

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[63] *Peoples Department Stores Inc. (Trustee of)* v. *Wise*, [2004] 3 SCR 461, 2004 SCC 68 at para 42.

[64] *BCE Inc* v. *1976 Debentureholders*, 2008 SCC 69, [2008] 3 SCR 560.

[65] Ibid., at para 66.

> Directors, acting in the best interests of the corporation, may be obliged to consider the impact of their decisions on corporate stakeholders … This is what we mean when we speak of a director being required to act in the best interests of the corporation viewed as a good corporate citizen. However, the directors owe a fiduciary duty to the corporation, and only to the corporation. People sometimes speak in terms of directors owing a duty to both the corporation and to stakeholders. Usually this is harmless, since the reasonable expectations of the stakeholder in a particular outcome often coincide with what is in the best interests of the corporation. However, cases (such as these appeals) may arise where these interests do not coincide. In such cases, it is important to be clear that the directors owe their duty to the corporation, not to stakeholders, and that the reasonable expectation of stakeholders is simply that the directors act in the best interests of the corporation.

In the four years that had passed since the *Peoples* case, some Canadian corporate observers appeared to be more comfortable with the stakeholder model. Anand seemed to praise the approach, finding that it allowed for "flexibility" when "balancing the interests of affected parties" (Anand 2009). Waitzer and Jaswal offered a qualified, yet optimistic, endorsement, noting that "the theoretical basis for a shift to directors taking a broader and longer-term view of corporate responsibilities is compelling" (Waitzer and Jaswal 2009).

Fraiberg seemed unconcerned, adding that as long as directors identified "stakeholders" and their "expectations", and made an informed decision in good faith that existed "within a range of reasonable alternatives", then the business judgment rule would protect them (Fraiberg 2009). Fraiberg was an astute corporate observer with a Bay Street practice (i.e., the Canadian equivalent to Wall Street), and a clear vision as to what was transpiring downtown. He suggested that Canadian corporate culture was maintaining business as usual; directors still continued "to maximize shareholder value", but merely reframed their decision-making processes, so as to not act "oppressively" (Fraiberg 2009). In other words, only the form – not the substance – of corporate decision making had changed with *Peoples* and *BCE*.

Puri, like Fraiberg, was also less concerned than the wave of commenters who reacted to the *Peoples* case, astutely noting that *Peoples* and *BCE* together granted directors a "wide discretion in making decisions" to conduct their affairs (Puri 2009). She hesitated before getting too excited about *Peoples* and *BCE*, suggesting that stakeholder empowerment was dependent upon "a range of factors beyond legal rules" (Puri 2009).

However, not all commentary was optimistic or unconcerned. Iacobucci was critical, arguing that *BCE* "fails to articulate a determinate fiduciary duty" (Iacobucci 2009). He added that whether one believes

that such fiduciary duties ought to be owed to shareholders or stakeholders, "it is difficult to defend a fiduciary duty that fails to guide either directors or courts" (Iacobucci 2009). VanDuzer worried about the wider discretion granted to directors, arguing they will "take comfort from the Court's strong endorsement of the business judgement rule", foreseeing: "self-serving behaviors … dressed up as protecting the best interests of the corporation by reference to the interests of one stakeholder or another" (VanDuzer 2009).

MacIntosh was also critical, arguing that *BCE* was "fraught with difficulties," having – along with *Peoples* – "thrust virtually all of corporate law into a state of uncertainty and confusion" (MacIntosh 2009). Since these issues would not likely be re-litigated any time soon, he pled to legislators to step in and "make it clear that directors' duties are owed to shareholders alone" (MacIntosh 2009). In the years since, the Supreme Court of Canada has been waiting patiently for another opportunity to revisit the matter.

7. FINAL REFLECTIONS ON CANADA'S MODERN CORPORATION

This chapter would like to end by providing a snapshot of the functional reality of Canada's modern corporation. Empirical data would shed light clearly upon the impacts of *Peoples* and *BCE*, as well as highlight the functional differences between Canadian and American corporate governance. Unfortunately, such data is in short supply; most insights are more anecdotal.

As to the reality of shareholder empowerment, Olasker and Moore, two top Toronto-based corporate lawyers, assert that Canada has a "plethora of undervalued companies" and a "persistent complacency about the quality of corporate management" (Olasker and Moore 2015). Although they acknowledge the formal regulations that open the door for enhanced shareholder activism, they suggest that shareholder pressure is not as significant as in the U.S. (Olasker and Moore 2015). Moreover, other careful observers of Canadian corporate governance, like Morck, largely agree with this assessment (Morck 2010).

As to the reality of stakeholder empowerment, the situation is similar to that of the U.S., which has not really changed since the Berle-Dodd debate of the early 1930s (Shareholder Primacy 2011). Those suspicious of managerial power, like Berle, still look to shareholder empowerment (Berle 1931, Ziegel 2005, Iacobucci 2009, VanDuzer 2009). At the same time, stakeholder advocates, like Dodd, are still strange bedfellows with

managerialists (Dodd 1932, Liao 2014). Yet, scholars, like Puri, appear ready to break the Berle-Dodd cycle, arguing that stakeholder empowerment is dependent upon "a range of factors beyond legal rules," which merely empowers management (Puri 2009).

Fraiberg was right, *Peoples* and *BCE* have merely changed the form of corporate decision-making – not the substance (Fraiberg 2009). No empirical studies directly support the claim that stakeholder empowerment is growing due to these cases. Moreover, only "a handful" of derivative action cases have ever been brought against Canadian directors for breach of their duty of care; and personal actions through the oppression remedy rarely involve public companies, and when they do, the plaintiffs almost never win (Cheffins and Black 2006).

In sum, although the CBCA holds the potential for both greater shareholder and stakeholder empowerment, the reality appears to be that managerial power is at least as entrenched as it is in the U.S. The most curious aspect of this conclusion is that the formal differences between the corporate laws of the U.S. and Canada – which this chapter has outlined and are noteworthy – do not appear to be enough to impact, in a meaningful way, the high degree of functional parallels between their corporate governance practices. This inference invites further research into the reasons why this appears to be the case.

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18. For- and non-profit special corporations in America, 1608–1860

Robert E. Wright[*]

1. INTRODUCTION

Corporations that formed in the United States and its colonial predecessors were both numerous and heterogeneous before the U.S. Civil War. For sake of exposition and analysis, corporations can be distinguished in myriad ways. Following Kyd (1793) and Kent (1827), Angell and Ames (1832), the first book-length legal treatise on U.S. corporations, divided them into aggregate corporations, or corporations composed of multiple persons, and sole corporations where an individual, like a monarch, bishop, or sole proprietor, was vested with corporate powers such as perpetual succession. Angell and Ames believed sole corporations were "not common in the United States" but legislators chartered at least 2,575 of them by special act of incorporation before the Civil War and they were common in the colonial period, especially for religious bodies in New England (Davis 1917). As Table 18.1 shows, for-profit sole corporations chartered after 1800 were quite common in some states but largely restricted to bridges, dams, ferries, and other minor internal improvement enterprises.

Another way to differentiate corporations is by the type of charter they received. In the early years, most U.S. corporations began their legal existence by authority of specific or special statutes called charters or acts of incorporation passed by the governments of the colonies or states where they physically operated. As the Civil War approached and the number of organizations seeking incorporation grew, however, busy legislatures increasingly delegated power to incorporate organizations to unelected bureaucrats under so-called general incorporation statutes

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Table 18.1 Sole corporations chartered by special Act, 1801–60

State	Number	Type	Number
Alabama	166	Bridges	610
Arkansas	49	Canals	25
California	43	Dams	130
Colorado	16	Ferries	1,101
Delaware	4	Fire companies	3
Florida	196	Fisheries	32
Georgia	267	Miscellaneous activities	6
Iowa	16	Manufacturers	13
Illinois	159	Mills	12
Indiana	21	Port facilities	301
Kansas	15	Railroads	31
Kentucky	4	River improvements	25
Louisiana	123	Stagecoach lines	15
Massachusetts	212	Steamboat lines	9
Maryland	4	Telegraph lines	3
Maine	52	Turnpikes	250
Michigan	113	Warehouses	3
Minnesota	123	Water utilities	6
Missouri	21		
Mississippi	79		
North Carolina	64		
Nebraska	16		
New Hampshire	14		
New Jersey	28		
New Mexico	1		
New York	210		
Oregon	2		
Pennsylvania	102		
Rhode Island	2		
Tennessee	73		
Utah	16		
Virginia	160		
Vermont	120		
Washington	1		
Wisconsin	83		
Totals	2,575	Totals	2,575

Source: Wright 2015a.

(Gunn 1988). Legislatures continued to charter corporations by special acts of incorporation well into the twentieth century, but after the Civil War most chartered organizations incorporated under general statutes (Hamill 1999). After legal changes in the late nineteenth century made it possible to engage in charter arbitrage, i.e., to charter in one state (first typically New Jersey but later Delaware [Wright 2014c]) but to operate mostly or exclusively in other states, special incorporation made little sense for most business enterprises. This chapter covers only corporations that received special acts of incorporation.

Early jurists divided aggregate corporations into public, i.e., municipal government or wholly government-owned, and private, i.e., everything else (Dodd 1954). In other words, they lumped business corporations together with religious, charitable, and other corporations (Kyd 1793, Kent 1827, Angell and Ames 1832). In this chapter, by contrast, specially-chartered corporations will be divided into for-profit (business) and non-profit categories as defined by Henry Hansmann (1996). Non-profit corporations, by Hansmann's definition, could be called non-owned corporations because they may produce profit in the sense of generating revenues greater than total expenditures. Those profits, however, cannot be distributed to the people who control non-profit organizations, so such organizations cannot rightly be said to have any owners. In fact, in the late nineteenth and early twentieth centuries, non-profits were sometimes called non-stock corporations (Lough 1909). Although anachronistic from a legal standpoint, the distinction between for- and non-profit organizations was clearly countenanced by early Americans, who referred to chartered for-profit joint-stock enterprises as "money" or "moneyed" corporations (Davis 1917). Later, some scholars differentiated between "pecuniary" and "non-pecuniary" corporations (Wood 1932).

Non-profit or non-pecuniary corporations were further divided into ecclesiastical (religious) and lay (secular), with the latter subdivided into civil (municipal) and eleemosynary (charitable) (Dodd 1954). For-profit corporations were subdivided into two types, joint-stock and mutual. The former were owned by their stockholders and the latter by their customers, typically their policyholders or depositors. Hybrids, partly owned by stockholders and partly by customers, also existed but they were relatively rare.

2. DEFINITIONS AND ORIGINS

Public corporations clearly date to antiquity and some scholars argue that private corporations are just as ancient (Lieber 1830, Angell and Ames

1832, Wright and Baughman 1947, Hansmann, Kraakman, and Squire 2006). The origins of the for-profit, joint-stock corporation remain somewhat murky, however, because since the late nineteenth century most scholars want limited liability to be the defining characteristic of the business corporation (see, e.g., Parker 1903). Such scholars reduce for-profit corporations that lacked limited liability, like those of ancient Greece, Rome, and India, to the status of proto- or quasi- corporations. They also deny the full corporate status of fifteenth century Germanic mining companies and numerous other medieval and early modern commercial entities that lacked limited liability (Livermore 1939).

A less anachronistic view, however, holds that any organization that enjoys the right of perpetual succession is properly called a corporation. The right of perpetual succession does not mean that the law guaranteed that the organization would exist in perpetuity. Indeed, many specially-incorporated U.S. businesses, most infamously the Bank of the United States (1791–1811) and the Bank of the United States (1816–36), contained explicit charter expiration dates (Cowen 2000). Rather, perpetual succession allowed organizations to change their owners/members without having to dissolve themselves as general partnerships had to do. Perpetual succession, in other words, created a legal entity that stood apart from its owners as a separate "body politic" or "body incorporate."

A common seal with the power to legally bind the corporation/entity, transferability of interests (shares or membership) in the entity, the right to sue and be sued in the name of the entity instead of in the names of each of its owners or members, the right of the entity to own property, the right to shield the entity from its owners' debts (entity shielding), and the right to shield the entity's owners from some or all of the entity's debts (limitations on liability), were additional ways of creating a legal entity separate from the legal identities of an organization's owners, employees, customers, and suppliers (Hansmann, Kraakman, and Squire 2006). Not all of those powers were unique to corporations and most were ineffective without the right of perpetual succession, which was therefore long considered the *sine qua non* of the corporate form (Kyd 1793, Kent 1827, Angell and Ames 1832).

None of this is to say that limited liability was unimportant, just that it should not be seen as the defining characteristic of the corporation, even the for-profit corporation. In fact, some states allowed the formation of partnerships with limitations on partner liability. That limited partnership form thrived in some states, like New York and Louisiana (Hilt and O'Banion 2009), while wilting in others, including New Jersey (Cadman 1949). Moreover, although silence on the matter of stockholder liability was taken to indicate limitation of liability (East 1938, Wright 2014a),

some early business charters explicitly imposed full, double, or proportional liability on stockholders but nobody questioned the corporate-ness of such organizations, all of which enjoyed perpetual succession (Livermore 1939, Perkins 1994).

Another point of controversy concerns the classification of organizations that asserted corporate powers but that did not receive explicit government sanction via a special act of incorporation or registration under a general incorporation statute. In colonial America and the early U.S., non- and for-profit organizations, often called "associations" or "companies," operated that purported to possess the right of perpetual succession and other corporate powers although they had not received a formal charter from a state or national government. Many such ventures purchased large tracts of land for resale to actual settlers, sometimes after clearing rivers for navigation, draining lowlands, or making other basic improvements. Some of those land companies claimed to be municipalities with an ancient, common law right to corporate prerogatives (Kyd 1793) while others followed Blackstone's suggestion that voluntary associations simply could assert some corporate powers without sanction so long as they were not explicitly forbidden from doing so by law (Angell and Ames 1832). Some of the unchartered companies tried to create by contract corporate powers not clearly countenanced by those common law loopholes, including most importantly limited liability, but the courts, which tended to be hostile towards unchartered business associations, never clearly ruled on the matter (Livermore 1939).

Unlike in the U.K., where many unincorporated companies flourished for decades (Freeman, Pearson, and Taylor 2012), unincorporated companies in the U.S. tended to form only when obtaining a charter proved too costly or politically difficult (Wright 2014a). After formation, however, most continued to seek, and eventually obtain, government charters because that was the only certain way "to limit the risk … to their shares in the stock of the association" (Angell and Ames 1832). The Associated Manufactoring Iron Company of New York, for example, promised subscribers in 1786 that company officials would apply for a charter so that "each Subscriber shall only be liable for the Company's Debts in proportion to his Interest in the Capital" (as quoted in East 1938:287). Kent (1827) also argued that demand for corporations was due in part to "the security which it affords to the persons of the members, and to their property not vested in the corporate stock."

Unchartered associations were also more likely to face double taxation than formal corporations were and acts of incorporation sometimes provided businesses with "special privileges," including monopoly or eminent domain powers, clearly not available to unchartered associations

(Angell and Ames 1832). Despite the liability, tax, and special privilege advantages of formal incorporation, a few business associations remained unchartered, but in operation, for decades (*Association of Centenary Firms* 1916). Their number included land companies like Dismal Swamp, the North American Land Company, the Connecticut Land Company, and the Holland Land Company, as well as manufacturing and mining companies such as Coventry Manufacturing and Lehigh Coal Mine (Livermore 1939).

3. CORPORATIONS BEFORE THE CONSTITUTION

British North Americans looked to Europe, and especially Britain, for legal and commercial guidance. While for-profit corporations were by no means numerous in seventeenth century Europe, they tended to be large, controversial monopolies infamous in the colonies (Scott 1910). Colonists also knew that some of the colonies themselves had been founded by corporations, including the Virginia Company of London and the Plymouth Company. The former folded in 1624 after making a financial hash of the colonization of Virginia. In 1629, the latter was essentially absorbed by the Massachusetts Bay Company, which colonists purchased and essentially extinguished the following year (Krooss and Gilbert 1972, Ver Steeg 1964).

Overall, colonial corporations were few compared to the post-Revolutionary period but the colonists were relatively few, poor, and constrained. In fact, most colonial corporations were non-profit because chartering them was politically and legally easier than incorporating businesses was. The pre-capitalist mentalité posited by some scholars was not an obvious factor in the seeming preference for non-profits. (For an extended critique of the mentalité scholars, see Lamoreaux 2003.)

Before the American Revolution, the mainland colonies of British North America chartered eight business corporations by the count of Wright (2015a), seven by the count of Davis (1917), and six by the count of Baldwin (1903). Baldwin missed three water utilities chartered in Rhode Island in 1772 but he included a New York fishery company established in 1675 and a society of traders established by William Penn in 1682. The common part of the three lists includes four concerns, Boston Pier, or the Long Wharf incorporated in 1772, the Union Wharf in New Haven, Connecticut chartered in 1760, the Philadelphia Contributionship (of which more below, chartered in 1768), and the New London Society United for Trade and Commerce chartered in Connecticut in 1732.

Davis (1917), along with Livermore (1939), chose not to count the Pennsylvania trading society, the Free Society of Traders, because it was chartered by the Lord Proprietor William Penn when he was in England, where most of the company's investors resided and the first company meeting was held. Moreover, they noted, the Pennsylvania legislature never ratified the charter and the enterprise was sued in the names of its trustees rather than by its corporate name. That seemed to place the Free Society into the category of corporations chartered in, and largely controlled from, Britain. That group was small because royal charters were costly to procure. It was composed of the aforementioned colonization companies, three missionary societies, including The Society for the Propagation of the Gospel in Foreign Parts chartered in 1701, and the College of William and Mary, the only colonial college directly incorporated by the Crown (Davis 1917).

On the other hand, Wright (2015a) and Baldwin (1903) included the Free Society. It was not at all clear that Pennsylvania's nascent legislature had to ratify Penn's charter as the right to charter corporations in Britain rested with the monarch, who could expressly delegate that authority to underlings such as Penn or the Durham County Palatinate. "It has long been an established maxim," Kyd (1793) noted, "that the King's consent is absolutely necessary … to the existence of all corporations." Moreover, Kyd continued, "no commonalty or corporation can make another corporation or commonalty, either by usage or prescription, or by any other means than by the authority of the King's charter empowering them to do so, by express words." The Free Society accepted Penn's charter in its bylaws further rendering any action by the Pennsylvania assembly moot. Moreover, after some questions about the legality of the bylaw, the Pennsylvania assembly explicitly recognized the corporation's existence, including in an act dissolving it after decades of de facto bankruptcy, which explains why the corporation's trustees were sued. Unlike most of the British-based corporations recited above, the Society, after its initial organizational meeting in England, met in Pennsylvania during its short active life. Finally, if the mere fact that some of its stockholders lived in England disqualifies it as an authentic American corporation, many corporations throughout the nation's history would have to be reclassified (Wright 2002, 2011a)!

The by all accounts few businesses that managed to obtain charters were able to do so because they did not arouse anyone's ire as they were either small, local, public-looking affairs like the wharves and water utilities, or, like the Contributionship, they were organized along mutual, rather than joint-stock, lines. For the most part, colonists declined to pursue high-risk, high-reward business ventures that seemed to demand

the corporate form, like banking (Smith 1776), because authorities repeatedly signaled their disapproval. The land and silver banks of Massachusetts proposed in 1740, two similar institutions suggested in New Jersey that same year, and a commercial bank in Philadelphia proposed in the mid-1760s and again in the early 1770s all folded when the Imperial government interceded (Wright 2005). It did so in 1741 by explicitly extending to the colonies the Bubble Act, which outlawed "the acting, or presuming to act, as a Corporate Body or Bodies, the raising or pretending to raise transferrable Stock or Stocks" (as quoted in Davis 1917, 1:26). In the Pennsylvania cases, attorneys simply reminded the would-be bankers that the Bubble Act had been extended to the colonies (Cochran 1979). Interestingly, many colonists supported the suppression of those and other large enterprises out of an ingrained fear and hatred of monopolies and banks (Livermore 1939). Such seems to have been the case with the New London trading society, the charter of which the Connecticut legislature repealed after less than a year when it became clear that the company was attempting to establish a land bank (Davis 1917).

The colonists' right to charter non-profit corporations, though never crystal clear, was generally acknowledged in the proprietary and royal colonies because their laws were subject to the approval of governors appointed by the proprietor or the monarch as well as the monarch him- or herself, directly and through the Board of Trade (Davis 1917). The charter colonies, which included Connecticut, Rhode Island, and Massachusetts before 1684, enjoyed the prestige of royal charters and corporate governments with the power to make laws not reviewable by the Crown. Their charters, however, did not explicitly grant them the power of chartering corporations themselves. So although it was admitted that the King could "give a general *power* by charter to erect corporations indefinitely" (Angell and Ames 1832), and Kyd (1793) allowed "that the corporation of London could make a fraternity or company so long as it was a voluntary association, from which each of the members may retire whenever he pleases" even though no King had ever explicitly bestowed it with that power, the right of the charter colonies to incorporate organizations remained unclear, except perhaps "in the case of eleemosynary or charitable corporations." The charter colonies chartered some organizations anyway, as noted, but not without controversy, even in the case of educational institutions like Harvard and Yale (Kaufman 2008). Georgia, which for its first 20 years was itself run by an English eleemosynary corporation, also chartered corporations under a presumption of its general powers (Davis 1917). All three New England charter colonies went to some lengths to hide their chartering activities,

for example by passing general incorporation-type laws that allowed any group of Christians to form churches with corporate powers without further government sanction (Goebel 1939).

Those laws, however, were not strictly necessary because the colonists believed that associations of freemen, acting under their own volition, could assert the basic powers of corporations, especially perpetual succession, without formal government sanction. Such associations, however, would not enjoy monopoly power or eminent domain and each of its owners could be called upon to pay the debts of their respective organizations. So they formed churches as voluntary associations even without the aid of explicit enabling laws like those of New England. Some municipalities also formed early on without seeking charters (Goebel 1939, Livermore 1939).

As noted above, extension of the Bubble Act to the colonies in 1741 cemented the notion that the colonies could not lawfully charter joint-stock corporations. Nevertheless, for-profit organizations asserting some corporate powers, including transferable shares, formed on the grounds of a hoary "popular notion … that substantially the same result [as incorporation] could be obtained by free association" (Goebel 1939). In fact, colonists established scores of for-profit quasi-corporate businesses via voluntary association or limited statutes that fell short of full-blown corporate charters. Those for-profit organizations included numerous fishing, whaling, Indian trading, and marine insurance companies as well as the Undertakers of the Iron Works (a.k.a. the Lynn Iron Works), Undertakers of the Glass Works, the Society of Particular Adventures for Traffique with them of Virginia in a Joint Stock, the Frankfort Company, the Principio Company, the Equivalent Land Company, Albemarle Furnace Company, the Simsbury copper mines, the Centerdale, Rhode Island saw mill company, the Baltimore Company (a.k.a. the Patapsco Iron Works), the American Iron Company, The Ohio Company (alleged by Baldwin [1901] to have received a charter in England in 1749), the Susquehannah Company, the Mississippi Company, the Illinois Company, the Indiana Company, Vandalia, Kennebec Company, the Potomac Company, the Dismal Swamp Adventurers, the Lake Superior Mining Company, the Linen Manufactory of Philadelphia, and the Company of Military Adventurers (Baldwin 1901, Davis 1917, Livermore 1939, Krooss and Gilbert 1972).

While the colonists' right to incorporate business enterprises remained suspect, their right to charter municipal corporations was relatively uncontroversial. The colonies chartered some two dozen cities and boroughs, most in the middle colonies of Pennsylvania, New Jersey, and New York. Other colonies tended to create simpler "corporate towns" or

"corporate counties." Pennsylvania and Maryland also chartered public corporations to oversee public education, charity, and land use (Davis 1917). In the first half of the 1760s, for example, Pennsylvania established eight "companies" charged with water drainage and land management. They were clearly incorporated but more like special purpose districts/municipalities than for-profit companies so they generally are not included in lists of colonial business or charitable corporations. Other colonies also chartered public corporations to construct and manage toll bridges and roads (Baldwin 1901, Davis 1917).

As aforementioned, the colonists eagerly established religious organizations, some as voluntary associations, some as corporations sole, and some under general incorporation laws. They also granted some churches, like the Dutch Protestant Congregation of New York (1696), special acts of incorporation. They also incorporated several benevolent societies for the relief of widows and children of clergy of different denominations, including Anglican, Presbyterian, and Dutch Reformed (Davis 1917). Some lay non-profits, including charities, educational institutions, libraries, and various voluntary associations, also benefited from colonial charters. Every colony except Delaware, North Carolina, and Georgia, for example, incorporated at least one educational institution (Davis 1917).

During the long reign of "benign neglect," American colonists worked together to solve their problems without the aid of imperial, colonial, or often even local governments. When a building was needed, for example, colonists pitched in to put it up in short order. When a fire threatened a home or shop, colonists worked together to try to extinguish it. When they failed, they helped victims to rebuild (Lemon 1972). Mutual cooperation continued even as the problems colonists faced became more complex, but it became more formal and organized.

Philadelphians were the first British North Americans to form numerous mutual self-help organizations (Roney 2014). In 1736, Benjamin Franklin created a more organized way of mutually fighting fires by organizing the Union Fire Company. Within a few decades, some 20 other companies organized along similar lines. In 1752, Franklin organized fire insurance along mutual lines by establishing the Philadelphia Contributionship for the Insuring of Houses from Loss by Fire (chartered in 1768), a model also eventually widely emulated (Knapp 1969, Wade 1959). Franklin also formed small mutual aid groups, like the Junto, too small to incorporate, as well as the more ambitious Library Company, which also spurred emulators and competitors (Hall 1992, Roney 2014).

Philadelphians also chartered private charities, including Pennsylvania Hospital in 1750 and Contributors to the Relief and Employment of the

Poor in 1766 (Davis 1917). Those, too, inspired emulation. In 1769, for example, South Carolina chartered the Fellowship Society hospital, which had been operating as an unincorporated association since 1762. According to Roney (2014), all told, colonial Philadelphians created at least 60 formal associations, including the Carpenter's Company, the Society of Ancient Britons, a Masonic Lodge, volunteer militia units, and various bachelor and hunting/fishing clubs. (Not all of those, however, received formal charters in the colonial period.)

New Yorkers also created various voluntary societies, including the New York Society Library (1754), Saint Andrew's Society (1756), the Chamber of Commerce (1768), the Society of Dissenters (1769), the Marine Society (1769), the Moot (1770), and the Society of the Hospital of the City of New York (1771) (Haley 1976).

During the Imperial Crisis, several non-profit voluntary associations, including the New York Society for the Promotion of Arts, Agriculture, and Oeconomy, Boston's United Society for Manufacturers and Importation and the Society for Encouraging Industry and Employing the Poor, and the United Company of Philadelphia for Promoting American Manufactures, formed to help encourage colonial manufacturers (Davis 1917, Peskin 2003) on the theory that by making more linens, woolens, and other goods at home, the colonies could improve their balance of payments and hence retain in colonial circulation more specie to fuel economies depleted of cash by various British Imperial policies (Gronim 1999, Michener and Wright 2010).

Chartering activity increased somewhat after the Revolution (1775–83) because independence removed the legal barriers to incorporation discussed above by placing chartering rights in the state (and eventually federal) governments (East 1938, Maier 1993, Goebel 1939). According to Kent (1827), corporations with colonial charters were either expressly chartered by the new states "or by general principles of public and common law of universal reception." Furthermore, any technical causes of forfeiture "during the disorders which necessarily attended the revolution" were forgiven. Nevertheless, incorporation, especially of for-profit ventures, remained a privilege and not a right. Moreover, the charters of some corporations, including those of the University of Pennsylvania and the Bank of North America, were summarily expunged of elements considered too aristocratic (Livermore 1939, Wright 2005). Macroeconomic difficulties during and after the war also stymied the rapid proliferation of corporations of all sorts (Buell 1998, Cochran 1932, East 1938, Wright 2008).

Chartering activity increased significantly only after passage of the U.S. Constitution (Davis 1917). About 20 businesses incorporated in the

1780s but over 10 times that number were chartered in the 1790s (Davis 1917, Wright 2015a). Corporations proliferated so quickly that Massachusetts elite James Sullivan complained that it was "a pity that so great a variety of corporations have been formed in this country before general rules for their government had been agreed upon" (as quoted in Hall 1992:22). Tench Coxe (1794) attributed the uptick in the pace of economic activity to the fact that "the views of the government of United States appear by its declarations, and by the strongest presumptive proofs to *the maintenance of peace, order, liberty and safety*." Although it took decades to sort out the major outlines of U.S. corporate law, the confidence that investors and incorporators placed in the new government proved well founded. The Constitution's overall property rights protections and its bar on the impairment of contracts prevented the dissolution of corporations without due cause or alteration of their charters without their consent (Angell and Ames 1832). Moreover, it created financial and economic systems in which relatively large organizations could thrive (Wright 2008).

4. FOR-PROFIT U.S. CORPORATIONS, 1790–1860

Although America was not always a "nation of joiners" (Neem 2008) and considerable anti-corporate, anti-monopoly, anti-big business angst was evident (Wright and Baughman 1947, Maier 1993), the corporate form came to dominate many areas of U.S. business sooner than in other developed countries, including even Britain to some extent (Hannah 2014, Lieber 1830, Wright 2014a). Specifically, between 1790 and 1860, inclusive, entrepreneurs throughout the U.S. received special acts of incorporation for 22,419 business corporations aggregate, 20,653 (92 percent) joint-stock (owned by stockholders), 1,459 (6.5 percent) mutual (owned by customers), and 307 (1.5 percent) hybrid (owned by both stockholders and customers). Detailed breakdowns by region, state, and industry are available in Sylla and Wright (2013), Wright (2011a, 2011b, 2014a, 2014b), Wright and Kingston (2012), and Wright and Sylla (2011). The entire dataset is available for download at Wright (2015a). While previous estimates of total business charters for several important individual states (e.g., Evans 1948) proved largely accurate, the best previous estimates for the entire nation were short by an order of magnitude because most scholars did not realize how rapidly business corporations proliferated in the Midwest and South, especially in the three decades before the Civil War (Wright 2014a).

In terms of governance, Americans thought of their early business corporations as mini-republics, not diminutive democracies (Rodrigues 2006). The right to vote for directors was important, but served as only one of numerous checks against self-serving behavior on the part of managers or large shareholders (Wright 2014a, 2015b). For example, stockholders could also call special meetings and had the right to veto important business decisions, like borrowing money by mortgage or bond (Cadman 1949).

Most corporations allowed shareholders to cast one vote per share but many, following Alexander Hamilton's prudent mean dictum, employed voting formulas that limited or even capped the number of votes that shareholders could cast. Precise breakdowns cannot be provided because most corporations established voting rules in their bylaws, few of which have survived, not in their charters. As Kent (1827) explained, *Newling v. Francis* (1789) established that when "the mode of electing corporate officers was not regulated by charter or prescription, the corporation might make bylaws to regulate the election," provided the bylaws did not infringe the charter or the law of the land. Angell and Ames (1832) also clearly stated that "where the mode of electing to corporate offices is not prescribed by charter, or immemorial usage, it may be wholly ordained by by-laws." Corporate ballots appear to have been secret "so as to avoid the odium and violence of party prejudice" (Angell and Ames 1832). So far as can be ascertained, one vote per share rules became more common over time because prudent mean rules and caps were increasingly circumvented by assigning shares to friends, family members, and other shills (Dunlavy 2006). Once elected, corporate officers usually had to post bonds "for their skill and faithfulness in the performance of their duties" (Angell and Ames 1832).

Sale of new stock in installments over time was another important check against malfeasance. Instead of selling their shares outright, new for-profit corporations issued "scripts" that converted into shares when fully paid up some months or even years after the corporation began operation. The subscription-installment mechanism provided investors with time to raise the funds needed to buy full shares but, more importantly, it served as a governance mechanism by essentially turning the scripts into de facto options to buy a full share. Investors who did not like the way a corporation was managed or governed could forfeit their right to full shares by simply not paying the installments. Corporations sometimes sued delinquent subscribers for the full par or book value of the shares they had subscribed but the courts lent them little support except in cases where subscribers had explicitly disavowed the right to forfeit their scripts for nonpayment. In such instances, subscribers had to

sell their scripts to other investors to terminate their liability (Angell and Ames 1832).

Stockholders also wielded considerable power to inspect corporate account books and physical property. "With respect to the members of a corporation," Angell and Ames (1832) explained:

> the books of the company are public books; they are common evidence, which must of necessity be kept in some one hand, and then each individual possessing a legal interest in them, has a right to inspect, and to use them as evidence of his rights. But with respect to a mere stranger, unconnected in interest, such books are to be considered as the books of a private individual, and no inspection can be compelled.

Notice of special meetings of members or stockholders had to be given and, if not specified otherwise in the charter or bylaws, that meant personal notice "served upon every resident member, or left at his house" (Angell and Ames 1832). Moreover, "in order to guard against and prevent surprise, the notice must be given a reasonable time before the hour of meeting." The meeting place and, if an important decision like an election, a change in a bylaw, or a major transaction was to be made, the reason for the meeting also had to be stated in the notice in order for the meeting's decisions to find support in court.

Other checks were external, like the doctrine, upheld by the U.S. Supreme Court in 1804 in *Heady & Amory v. The Providence Insurance Company* (2 Cranch 127), that corporations only possessed those powers "specifically granted by the act of incorporation, or as are necessary for the purpose of carrying into effect the powers expressly grant, and as not having any other" (Angell and Ames 1832). "If the object of the corporation is to *insure property*, for instance, it cannot [lawfully] exercise the power of acting as a *banking* institution" (Angell and Ames 1832), a doctrine, called ultra vires, that Kent (1827) considered "obvious" and well supported by state courts because it protected donors, stockholders, and society from rapacious trustees or directors (Hovenkamp 1991).

A related doctrine, called quo warranto for the action brought, stipulated that corporations actually had to complete the improvement(s) or perform the services mentioned in their respective charters. By the time Angell and Ames (1832) wrote, it was "well settled, that it is a tacit condition of a grant of incorporation that the grantees shall act up to the end or design for which they were incorporated; and hence through neglect or abuse of its franchises a corporation may forfeit its charter, as for condition broken, or a breach of trust." Quo warranto proceedings

could also stop corporations from engaging in activities not allowed by their charters (Cadman 1949).

5. NON-PROFIT U.S. CORPORATIONS, 1790–1860

Scholars know that non-profits abounded in the early national and antebellum periods. Kaufman (2008), for example, found that between 1780 and 1810 new non-profit charters outnumbered business incorporations in the 13 original states. In addition, the ubiquity of non-profits was pointed to by the same contemporary observers who accurately asserted that for-profit corporations were extremely numerous. After his 1831 tour of the U.S., Alexis de Tocqueville (2000) wrote:

> Not only do they have commercial and industrial associations in which all take part, but they also have a thousand other kinds: religious, moral, grave, futile, very general and very particular, immense and very small; Americans use associations to give fetes, to found seminaries, to build inns, to raise churches, to distribute books, to send missionaries to the antipodes; in this manner they create hospitals, prisons, schools.

Angell and Ames (1832) noted:

> These associations we not only find scattered throughout every cultivated part of the United States, but so engaged are they in all the varieties of useful pursuit, that we see them directing the concentration of mind and capital to the advancement of religion; to the diffusion of literature, science and the arts; to the prosecution of plans of internal communication and improvement; and to the encouragement and extension of the great interests of commerce, agriculture, and manufactures.

Gunn (1988) categorized early U.S. non-profits into improvement associations (agricultural, manufacturing, medical, science, transportation); reform associations (abolition, alcohol, peace, poverty, prostitution); religious organizations (Bible, church, missionary, Sabbatarian, Sunday school); charitable and benevolent societies; fraternal orders; education associations (academies, colleges, libraries, and lyceums); volunteer service (fire, militia); and labor associations (protection societies, trade unions, worker cooperatives). He might have added trade associations, such as the Association of New York Publishers (Howe 2007) and the New England Association for the Suppression of Counterfeiting (Mihm 2007).

Despite the general consensus that non-profits were numerous, Skocpol (2003; Skocpol, Ganz, and Munson 2000) correctly noted that “there is

no handy reference book – or computer disk – to which one can turn to map the rise and fall, the purposes and forms, of voluntary associations throughout U.S. history." Rather than lament that fact, or simply call the number of antebellum non-profits "countless" as Blumin (1989) did, this section surveys what is known, including the initial findings of an extension of Wright (2015a) to the non-profit sector.

Not all non-profit organizations sought, or received, charters. Like unincorporated joint-stock companies, some non-profits formed under articles of association and asserted corporate rights. Limitation of liability was less important because non-profits tended to be lenders rather than borrowers but entity shielding was a major consideration. Moreover, the right to sue and be sued in a corporate name was valuable because it was more convenient for the organization's officers and trustees and protected them from personal lawsuits (Angell and Ames 1832). Formal incorporation by special act was undoubtedly less costly for non-profits than for banks and probably most other business corporations (Ginzberg 1990). The First Female Beneficial Society of Pennsylvania, for example, expended just $20 to obtain its charter (First Female Beneficial Society of Pennsylvania 1814). Many early worker cooperatives began operating as unincorporated associations but soon found it expedient to incorporate in order to enjoy corporate rights like the use of a common seal (Curl 2009). In return for their corporate "privileges," however, non-profit corporations were regulated in various ways. Some had their annual income limited by law, presumably to prevent them from turning into dreaded "monopolies" (Northern Dispensary 1816).

Despite the advantages of formal incorporation, smaller non-profit organizations without significant resources, like sporting clubs and dance assemblies, typically found it too costly or troublesome to incorporate (Blumin 1989, Wood 1932). In addition, politically marginal groups, like free blacks, may have found formal incorporation of their beneficial and benevolent societies too costly to pursue (Curry 1981, Palmer 1944). Irish immigrants, by contrast, were able to charter non-profits like the St. Patrick Benevolent Society, "which was an association having for its object, the raising a fund to be applied to the relief of its members in case of sickness and misfortune, and to the assistance of distressed Irishmen, emigrating to the United States" (Angell and Ames 1832).

Some antebellum non-profits formed under general incorporation statutes, like those passed by New York for churches (1784), county loan officers (1786), colleges and academies (1787), libraries (1796), county medical societies (1806), and Bible societies (1811) (Gunn 1988). Pennsylvania and other states also passed general incorporation laws for religious organizations (Angell and Ames 1832, Davis 1917). New Jersey

passed general incorporation acts for schools (1794), benevolent and charitable associations (1844, 1853), societies for the protection of property (1851), and rural cemeteries (1851) (Cadman 1949). North Carolina passed a general act for non-profit canals in 1795, Massachusetts passed one for water utilities in 1799, and Virginia and Kentucky did likewise for fire companies in 1788 and 1798, respectively (Davis 1917). The number of general statutes increased as the Civil War approached. Indiana, for example, passed several general incorporation laws for non-profits before 1851, when its new constitution banned special acts of incorporation for non-banks, thereby necessitating the passage of numerous general statutes for a wide variety of voluntary associations in 1852 and thereafter (Wood 1932).

Thus far, precise counts of non-profit U.S. corporations created by special act of incorporation before the Civil War have been compiled for four states – Arkansas (82), Iowa (54), Kentucky (898), and South Carolina (754) – for a total of 1,788 non-profits. Those same states over the same period chartered 1,514 business corporations (Wright 2015a). Assuming their ratio of non-profit to business charters (# of nonprofits/# of for profits = 1.18) is near the national average, that yields an estimate of 26,454 (22,419 × 1.18) non-profits specially chartered throughout the nation between 1801 and 1860. Non-profits were so numerous because when associating is unrestricted, as it was in the early U.S. to a large extent, "each new need immediately awakens the idea of it," de Tocqueville (2000) explained. "The art of association then becomes … the mother science; all study and apply it."

Counts of non-profits in specific cities and regions have also been made. In 1830, for example, John Quincy Adams listed 23 non-profits, with endowments totaling almost $1.2 million, active in the Boston area. Another admittedly incomplete census undertaken in Boston in 1845 listed scores of new organizations: 31 societies "having religious objects," 26 "for purposes of literary education," 25 "for the relief of physical and moral wants," and 31 others with "objects of more or less general interest" (Eliot 1845). Through a combination of primary and deep secondary source research, Brown (1974) uncovered the existence of over 300 charitable institutions in Boston and non-Boston Massachusetts (including Maine) before 1830. By that time, over 200 civic organizations, 400 education non-profits, 100 occupational societies, and some 3,000 religious organizations (most Christian) had also formed in greater Massachusetts.

Using the directories of a sample of five major and 10 minor cities, Gamm and Putnam (1999) estimated associational density per 1,000 inhabitants at about two in the last two decades of the antebellum period.

Churches and religious organizations accounted for about half of that, with fraternals a close second by 1860.

In addition to city and regional estimates, spot estimates of varying degrees of specificity have been made for several different types of voluntary associations. Some of the estimates were quite vague. All that Howe (2007) dared to claim about benevolent associations was that the list of them was so "long and bewilderingly varied" that even contemporaries simply labeled the whole mass "the Benevolent Empire" or the "Evangelical United Front." Knapp (1969) concluded that "hundreds" of county agricultural societies formed after the 1810 establishment of the Berkshire Agricultural Society, which served as a model for other farmers in New England and the seaboard states eager to help improve agricultural yields through experimentation and education. Scholars have also determined that over 100 trade societies formed in New York, Baltimore, Philadelphia, and Boston between 1833 and 1837 (Commons et al 1918).

Other scholars have developed much more specific estimates. Haveman (2015) counted 1,534 antislavery societies formed before the Civil War. Szymanski (2005) uncovered 72 protective societies designed to reduce theft in antebellum New England. Almost two dozen "vigilant societies" tried to do likewise in New Jersey (Nicolosi 1968). (Apparently, however, no horse protection associations formed in Wisconsin until after the Civil War [Luckett 2007–08] and Indiana passed a general incorporation act for them in 1852 [Wood 1932]. One formed in south-eastern Pennsylvania did little other than have an annual dinner meeting and place advertisements in newspapers and with toll keepers but was effective enough to maintain a score or more members for decades [Oxford Horse 1854].) By 1820, 38 colleges had formed nationwide (Dodd 1954). By 1830, 168 academies had formed in New England alone (Opal 2008). In 1850, the *Baptist Almanac and Annual Register* and the Census Bureau counted over 40,000 active churches in the U.S. In 1832, 4,258 Sunday schools were active (Newman and Halvorson 2000).

Scholars have also discovered that certain types of non-profits simply did not exist before the Civil War, or existed at very low frequency. Few non-profit pawnshops, for example, were established because most early Americans found the notion of pawning personal goods at high rates of interest anathema so most non-profits, like the Chattel Loan Company, were quickly shuttered. The first successful non-profit pawnshop, the Collateral Loan Company (later the Pawner's Bank of Boston), was not incorporated until 1859 (Woloson 2009).

Other non-profits were even more controversial in some circles but nevertheless successful. In July 1823, for example, over 300 South Carolinians joined the South Carolina Association, an organization

formed to enforce laws designed to control the state's free black population. Perhaps its most infamous action was suing sheriffs to enforce the Negro Seaman's act, a controversial and hastily composed statute that had banned black sailors from entering South Carolina ports on the theory that they infected free and enslaved blacks with Northern and British abolitionist sentiments and provided slaves with opportunities to escape bondage. The law had gone largely unenforced because it clearly challenged the federal government's power to regulate interstate and international commerce. Bolstered by the charter it received in December 1828 and despite several rebukes in federal court, the South Carolina Association remained a potent pro-slavery think tank and political action group throughout the antebellum period (Freehling 1965, Rich 2005, South Carolina Association 2001).

Skocpol (2003) documented a dozen national civic organizations formed in the antebellum period that eventually came to enroll more than 1 percent of the eligible population. They were, in order of their formation, the Ancient and Accepted Free Masons, the Independent Order of Odd Fellows, the American Temperance Society, the General Union for Promoting Observance of the Christian Sabbath, the American Anti-Slavery Society, the Improved Order of Red Men, Washington Temperance Societies, Order of the Sons of Temperance, Independent Order of Good Templars, the Young Men's Christian Association, the Junior Order of United American Mechanics, and the National Education Association.

Some of those associations were truly massive, claiming by the start of the Civil War hundreds of thousands of members enrolled through thousands or even tens of thousands of local chapters or lodges. Begun in 1819, the American Order of the Odd Fellows (and the affiliated Rebekah Degree for females) by early 1826 boasted 16 lodges in four states. By 1844, just a quarter century after it began operations in the U.S., it claimed 26 grand and 457 subordinate lodges, 40,238 members, and revenues in excess of $283,000. In 1855 alone, it paid out over $373,000 for relief of "brothers," almost $70,000 for the relief of widowed families, over $12,000 for the education of orphans, and almost $93,000 for burying the dead. By the start of the Civil War, the organization was truly enormous; it had over 400,000 members by 1873 (Ross 1888). Temperance also drew a six-figure membership all told (de Tocqueville 2000); the Good Templars alone boasted 53,200 members by 1858 (Dannenbaum 1984).

Other national associations were smaller but still of impressive size. The Red Men counted 10,000 members in 94 "tribes" spread across "reservations" in eight states and the capital district. Others, smaller still,

were nevertheless major niche players among specific ethnicities or nationalities. The Ancient Order of Hibernians, for example, had branches in eight states after forming in 1836 and counted a significant percentage of Irish-born immigrants among its members. The same could be said of Czech immigrants and the Bohemian Slavonic Benefit Society, formed in 1854, and Germans and the Order of the Sons of Hermann and the Order of Harugari. Although the top leadership of such organizations has been identified as largely new or aspiring upper-class merchants and professionals (attorneys, doctors, financiers), the social composition of the middle and lower rungs of the membership remains less certain. The sheer size of their membership rolls, however, suggests large numbers of clerks, artisans, mechanics, small retailers, and farmers must have composed the bulk of the rank and file, especially of the largest voluntary associations (Blumin 1989).

Claims to the contrary notwithstanding (Skocpol, Ganz, and Munson 2000), most antebellum non-profit organizations were small, local affairs. The big, national associations did not come to dominate the voluntary association scene until the late nineteenth and early twentieth centuries. Before the Civil War, the national associations may have enrolled more individuals than all the local non-profits combined but any small group that sought independence from a national organization could achieve it at relatively low cost. Thus, rather than invite schism by adopting the federal structure of most of the other large voluntary associations, the Washingtonian temperance societies remained financially and legally independent from each other yet were united by a common culture, governance principles, and goal (Blumin 1989). Grosh (1842) described the inner workings of the Washingtonian temperance societies, which "absolutely forbid the introduction of sectarianism, party politics, denunciation or harshness" or anything else that distracted members from their mission, the prevention and cure of what we today call alcoholism.

Like for-profits, many non-profits ceased operations after short stints. Many producer and worker cooperatives, for example, dissolved following internal ideological schisms or macroeconomic downturns (Curl 2009). Non-profits struggled to achieve their goals more due to weak incentives, collective action problems, and competition (from other non-profits, governments, and/or businesses) than governance or structural problems with the corporate form. In 1785, for example, the Philadelphia Society for the Promotion of Agriculture formed to improve agricultural techniques through education, experimentation, and prizes. Comprised of a mix of business and professional men as well as practicing farmers, the Society could claim modest success in the

dissemination of knowledge in the fields of crop rotation, seed improvement, pest control, and manure and gypsum use before it was shuttered in the early 1790s (Ellsworth 1968, Knapp 1969). At least six more agricultural promotion societies cropped up, from New England to the Deep South, before the end of the century. The societies sought to increase yields by identifying, disseminating, and rewarding best practices (i.e., techniques as well as technologies) (Peskin 2003). In this, they were successful (or at least did not get in the way) because yields markedly increased across numerous crops throughout the first half of the nineteenth century (Thornton 1989, Olmstead and Rhode 2008).

Similarly, the Pennsylvania Society for the Encouragement of Manufactures and the Useful Arts, formed in 1787, was the first of about a dozen manufacturing societies to spring up before 1800. Like their agricultural brethren, the manufacturing societies offered education as well as prizes for achievement of certain goals but they did not disseminate trade secrets (Ben-Atar 2004) or other sensitive technical information and some even engaged in manufacturing themselves (Peskin 2003). Their membership lists included both Federalists and Democrat-Republicans (Jeffersonians) but they almost all agreed on one thing, the need for protective tariffs. Other pro-tariff voluntary associations included the American Society (1816), the Connecticut Society (1817), Philadelphia Society for the Promotion of Useful Industry by Protective Laws, and the National Institution for the Promotion of Industry. Together, they helped to induce the passage of the so-called Tariff of Abominations in 1828 but watched helplessly as average tariff rates were cut by two-thirds by 1840 before tariffs began trending upward again (Krooss and Gilbert 1972).

Many of the governance checks available to business corporations were also available to non-profits. A court quashed an attempt to impose a hefty poll tax on members of a certain Anglican church, for example, because it ran counter to the act of incorporation (Angell and Ames 1832). Non-profits adopted innovations derived from the governance of for-profit corporations, including the dissemination of printed annual reports (Neem 2008), but they remained much more likely to allow only one vote per member rather than one vote per share (Curl 2009).

In terms of voting, quorums, meetings, and so forth, the common law held unless the charter or bylaws explicitly provided for some other arrangement, all of which the courts upheld so long as the bylaws were lawfully agreed to and did not violate the constitution or positive law. A court held, for example, that a member of a Pennsylvania benevolent institution could not be automatically expelled for neglecting to pay his contribution for three months, as specified in the organization's charter,

because the action denied the member due process. "He might either have proved that he was not in arrear," Angell and Ames (1832) explained, "or have given such reason for his default, as the society might have deemed sufficient."

Non-profit law, however, somewhat evolved away from business corporate law over the first half of the nineteenth century (Dodd 1954). Civil, eleemosynary, and ecclesiastical corporations, for example, were subject to "visitation" or monitoring by individuals named in charters or other founding documents. Courts typically served as visitors in the case of municipal corporations, founding donors or their appointees in the case of charities, and church officials in the case of religious organizations (Angell and Ames 1832). Visitors were powerful. As Kent (1827) explained, they constituted "a domestic tribunal, possessing a jurisdiction from which there is no appeal." Moreover, unlike business corporations, eleemosynary corporations also did not automatically possess an "incidental power of legislation," i.e., the power to make their own by-laws, because they were, as Angell and Ames (1832) put it, "the mere creatures of their founder." Even visitors could not change the bylaws laid down by the founder unless expressly authorized to do so.

Donors drew legal support on the basis of "the power every one has to dispose, direct, and regulate his own property" (Angell and Ames 1832). More practically, philanthropists were less likely to contribute to organizations that denied them control. When approached with a request to donate $10,000 to a state-run hospital for the insane, Philadelphia merchant and philanthropist Thomas P. Cope demurred, noting in his diary that if the state was to control the institution "then let the State provide means for its erection & maintenance without calling on individual to do it or to enter into partnership with them in the accomplishment of the object." Cope was certain that "experience teaches me that the Institution in its incipient state & after management would be placed in the hands of partisans selected, not for their competency, but as rewards for political sycophancy" (Harrison 1978).

For- and non-profit corporations were subject to the writ of mandamus, or a command by a court, in the name of the sovereign power, requiring the corporation "to do a certain specific act" like observing "the ordinances of their constitution" or respecting "the rights of those entitled to participate in their privileges" (Angell and Ames 1832). A mandamus could be used, for example, to compel an insurer to elect a new officer if it failed to do so as specified in its charter. Courts usually used a writ of mandamus, however, to force religious organizations and charities, which were not subject to quo warranto proceedings, to comply with their charters or other laws (Angell and Ames 1832).

Certain other legal issues unique to non-profits raised their costs (Hall 1992). "It has been a question of grave import, and difficult solution," Kent (1827) reported, "whether a corporation instituted as a charity, could be permitted to become the *cestui que trust* [trust beneficiary] of lands devised for charitable uses." Similarly, early courts did not consider subscriptions to eleemosynary corporations binding if "the paper was signed before the corporation was created" (Angell and Ames 1832), a doctrine that of course made it more difficult for charities to collect pledges made prior to their incorporation. Some states also limited the amount of property that non-profits could lawfully hold and some even forbade bequests, signaling their animosity by repealing the Statute of Charitable Uses (1601), presumably because government officials saw non-profits as threats to the power of the state (Brooke 1989). Only with the Supreme Court's decision in *Vidal v. Girard's Executors* in 1844 did the federal government express support for the property rights of non-profits. According to Hall (1992), it was only after the Civil War that "advocates of private power concentrated their energies [on] … extending the scope, scale, and legal privileges of private eleemosynary institutions."

Many non-profits found it difficult to keep members and leaders actively engaged. The meetings of the Philadelphia Agricultural Society, for example, were attended by only 11 people on average and initiatives frequently foundered for years before being executed. That meant that the society had insufficient funds to issue publications, run model farms, or even create a library. Its relative inactivity, in turn, further decreased interest in the organization, which was largely moribund after 1793 (Ellsworth 1968).

According to Cope, the Philadelphia Almshouse was:

> less useful to the poor & less beneficial to the community than it might be under a more judicious system of laws. The change of managers is too frequent, nor have they sufficient power to control the conduct & employment of the paupers. Hence the establishment is expensive & ill conducted. … the frequent changes of managers give to none a fair opportunity of becoming acquainted with his business or of digesting, arranging & pursuing any regular plans of internal economy (Harrison 1978).

But volunteer managers could burn out before they learned how to run the organization, leaving non-profits with a difficult conundrum most often solved when they could afford to pay their leaders good salaries or provide them with adequate soft benefits like important business or political connections.

Nevertheless, some non-profits were able to muddle through thanks to luck or the extraordinary exertions of dedicated leaders or members. When he worked as manager of the Pennsylvania Hospital for the Insane, for example, Jacob G. Morris was said to perform "his duties with the greatest willingness and punctuality," which apparently was unusual because the hospital board claimed that they had "never had a more faithful and zealous member" (Breck 1854).

Philadelphia's Northern Dispensary for the Medical Relief of the Poor, a charity hospital formed in September 1816 and formally chartered in early 1817, also found a formula for success (Northern Dispensary 1816). Contributors had the right to place two patients "under the care of the Dispensary" at the same time for every $3 they donated annually. Larger contributors received the right to place two patients in the hospital simultaneously for the rest of the contributors' life for every $30 donated in a lump sum. Regardless of the size of their contribution, donors who took the time to attend the annual meeting also could cast one vote for the hospital's dozen managers, who, in turn, selected the hospital's "attending Physicians & Surgeons, an Apothecary & Treasurer." In any early meeting, the managers made clear that "no persons will be received objects of this Charity but such as are really necessitous."

In addition to smaller contributions from persons who sought to recommend poor people to the hospital for care, the Northern Dispensary also received contributions and bequests large enough to merit their investment. Like other early charities, it invested in U.S. government bonds as well as mortgages and ground rents, a form of perpetual mortgage common in urban Pennsylvania and Maryland (Wright 2005). In the late 1810s, the hospital expended between $750 and $1,700 to treat almost 1,000 poor Philadelphians per year. In the early 1820s, in the aftermath of the Panic of 1819 and the recession it spawned, it treated over 1,500 patients per year on about the same income. "When it is considered how much relief is afforded to the indigent sick by a small sum appropriated to the support of the Dispensary," president George Boyd boasted, "the managers confidently hope that their benevolent fellow citizens will not permit so useful an Institution to languish for want of pecuniary aid." As the economy improved, the number of patients dropped and donations remained fairly constant, leading to a surplus that the institution's treasurer invested in U.S. government bonds. When those were paid off in 1830 as part of the federal government's drive to pay off the entire national debt (Wright 2008), the hospital invested excess funds in mortgages and corporate bonds, including those of the Schuylkill Navigation Company.

A similar cycle occurred in the 1830s, when the Panic of 1837 spurred a recession that lasted until the mid-1840s. In 1843, the Dispensary treated 1,884 patients (1,243 females and 641 males), administered 8,921 prescriptions, and performed 160 cuppings, 68 bleedings, and 81 leechings. It also oversaw the removal of 423 teeth. Revenues from contributors and investments improved but by late 1844, the managers, "with a view to economy alone" had to implement cost-savings measures and make other reforms. The hospital survived the financial difficulties, however, and managed to treat 3,541 patients in 1849, while also funding 6,953 prescriptions and almost 1,100 tooth extractions.

The Northern Dispensary was able to persevere due to its quality leadership. Not all the many charities and benevolent associations, however, could find good leaders. In March 1846, for example, the Deaf and Dumb Asylum of Philadelphia elected local elite Thomas P. Cope to its board of managers. "Why did they elect me?" Cope confided in his diary. "I have no expectation of becoming an active member, owing to the press of other engagements." Two years' later he called the institution "noble" and "useful" but admitted that he had rarely performed his duties "other engagements prevailing." Indeed, his diary noted his attendance at only two meetings in four years. The Asylum undoubtedly tapped Cope because earlier in his career he had ably served the Pennsylvania Hospital, which Cope had helped to make "a noble establishment & ably conducted" (Harrison 1978).

Non-profits were especially prone to shocks, especially if founders moved on and new leadership did not emerge. The managers of the Pennsylvania Institution for the Instruction of the Blind, for example, thanked Jacob G. Morris for promptly stepping up after "the sudden resignation and departure of the former Principal" of the corporation, which staved off a "crisis" in its affairs at the sacrifice of Morris's "personal convenience … time and abilities." Although the duties of the office were "delicate and important," Morris provided them gratis (Breck 1854).

In lieu of money, non-profit leaders like Morris and Cope typically sought social status and the "soft power" and connections that came from leading voluntary organizations, which served as semi-public spaces where men from different classes, occupations, political parties, religions, or regions could interact, form friendships and alliances, and so forth (Doyle 1977). "Strangers," recruiters for the Good Templars pointed out, "seek in the lodge room worthy acquaintances … and others with aspirations after a higher life leave the card tables and billiard saloons, and unite with the Order" (as quoted in Doyle 1977).

6. CONCLUSION: A NATION OF CORPORATIONS AND CORPORATE STAKEHOLDERS

Numerous historians have stressed early Americans' angst concerning corporations. Some have even perceived an "anti-corporate" vein running through American history. Few early Americans, however, provided cogent critiques of the corporate form. What really bothered them were monopolies and other forms of rent-seeking and the best way to combat both was to charter *more* corporations so that they would compete against each other in the marketplace and check each other in the political realm, as Smith (1776) argued. The logic of competition also extended to non-profits, even religious organizations. Allowing numerous churches would ensure that none of them grew "considerable enough to disturb the public tranquility." Smith (1776) also noted that in Pennsylvania, although "the Quakers happen to be the most numerous, the law in reality favours no one sect more than another," so the colony enjoyed "good temper and moderation" in religious matters.

It is unsurprising, then, that early U.S. states chartered many more corporations than their economic peers in Europe. "In no country," Angell and Ames wrote (1832), "have corporations been multiplied to so great an extent, as in our own." Moreover, participation was widespread. "There is scarcely an individual of respectable character in our community," they claimed, "who is not a member of, at least, one private company or society which is incorporated." The large membership rolls of the non-profits discussed above, combined with the widespread ownership of corporate shares documented by Majewski (2006), Wright (2002), and others, supports the view of Angell and Ames as well as that of de Tocqueville (2000).

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19. Legitimating power: a brief history of modern U.S. corporate law

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The history of modern corporate law and theory begins with the early twentieth century's obsession with corporate power and means to channel it for the social good. It continues after the New Deal as jurists' attention turns to internal hierarchies and the need to enhance both democracy and expert management. It ends as postwar neoclassical economics and modern finance theory dissipate concerns about corporate power and hierarchies. Emphasizing the role of the free market in taming corporations, finance and economics have helped pacify investors while ensuring the unquestionable reign of corporate managers. Law's role was reduced to enabling the development of powerful corporations unchecked by law.

This chapter traces this history of corporate law in the evolution of directors' fiduciary obligations. I argue that American legal scholars have embraced the giant corporation and focused on taming its economic, social, and political powers by imposing duties on corporate managers. As attention shifted from power to hierarchy to markets, jurists moved from viewing directors as trustees, to describing them as the shareholders' representatives, to holding that directors were agents of the shareholders—the passive principals. Each of these labels implied a particular standard of review of directors' conduct—trustees were subjected to the heightened requirements of care and trust. When directors were labeled representatives, their actions passed muster under the more lenient standards of business judgment and fairness. At the dawn of the twenty-first century, the actions of directors as agents have been subjected to minimal procedural scrutiny and ultimately evaluated under the subjective standard of good faith.

Changing concerns about the securities markets invigorated the transition from trust to business judgment and fairness to good faith. During the early decades of the twentieth century, legal scholars viewed directors' duties as a means of preventing market manipulation by the control group. By midcentury, concerns about the securities markets subsided as legal scholars embraced corporations as critical to the country's success.

Fiduciary duties became a means of allowing managers expertly to run their corporations' affairs. In the last decades of the twentieth century, jurists accepted modern finance theory's emphasis on the shareholders' ability to protect themselves by diversifying their portfolios. Without fears or concerns, all that was left of the directors' duties was the requirement that directors and officers follow certain processes and do not act in (subjective) bad faith.

The first part of this chapter explores scholarly discussions of market manipulation and the corresponding fears that corporate managers would abuse their power. These concerns set the foundation for subjecting directors to heightened fiduciary obligations toward their corporations, their shareholders, and the community. The second part explores how corporations endeavored during the 1930s and 1940s to portray a harmonious vision of the corporation's place in American society. This vision substantiated a different view of the relationship between managers and their corporations. Courts used the standards of business judgment and fairness to enable managers skillfully to run their corporations as the shareholders' representatives but without interference from the shareholders. The third part begins with the development of the monitoring model of the board with its emphasis on the role of independent directors. It then examines how the Delaware courts used the independent directors to turn business judgment and fairness from substantive standards of review to procedural ones, a shift supported also by the judiciary's embrace of modern finance theory and the neoclassical economics' description of directors as the shareholders' agents. The fourth part ends with the courts' turn to good faith at the turn of the twenty-first century. Trusting, rather than dreading, the securities markets and, perhaps more important, managers of mutual funds to protect the interests of shareholders, the Delaware courts used the good faith standard to avoid any substantive review of directors' and officers' actions.

How, then, could investors continue to trust their managers? As this chapter suggests, courts have used the rhetoric of trust, business judgment, fairness, and good faith not only to offer different meanings to directors' and officers' duties but also to ease investors' concerns. By carefully describing the required conduct as grounded in fiduciary obligations while using growingly less stringent standards of review to evaluate claims that directors breached their duties, the courts conveyed a consistent message to investors about the trustworthiness and expertise of their corporations' directors and executives. Rarely finding corporate managers to have breached their duties, the courts helped assure investors that their trust in their corporation's managers was justified. Without

liability but with detailed analyses of the appropriate standards by which directors' conduct would be evaluated, the courts legitimated the empowerment of corporate directors and officers outside the court. By the turn of the twenty-first century, rhetoric trumped law.

I. POWER AND TRUST—1900s–1930s

The turn of the twentieth century witnessed a dramatic growth in the scale of private business organizations. Increasing consumer demand, rising numbers of skilled and unskilled workers, and an expanding pool of capital made the creation of large enterprises possible while corporate lawyers created a variety of legal devices to help their clients increase the scope of their operations so as to avoid destructive competition among medium to large businesses seeking to gain enough revenue to pay high fixed costs (L. Mitchell and D. Mitchell 2010).

Efforts to control the growing corporations had little effect. A number of states had passed strong antitrust laws to assuage their rural population's fears about the power that large companies held over prices of farming and living necessities. In 1890 Congress passed the Sherman Anti-Trust Act and in 1898 President McKinley appointed nine people to the Industrial Commission to study, most important, the trust problem. But state corporate laws accommodated the industrialists' needs, undermining state and federal antitrust regulation. Beginning with New Jersey, states modified their corporate laws to give boards more power to order the affairs of their corporations. These laws allowed corporations to own and vote the stock of other corporations, incorporate for any lawful purpose, operate entirely out of state as long as they maintained a registered office in the state of incorporation, and use their own stock to buy assets, including the stock of other companies. By the 1890s, gone was the nineteenth-century corporation, which was subjected to strict constraints on its powers as well as limitations on its capital structure. Trusts, holding companies, and mergers became common, even if often contested in state courts (Horwitz 1992; L. Mitchell 2007; Ott 2011).

The modern stock market developed in sync with the giant corporation. Beginning with the merger wave of the 1890s, corporations drew investors, typically of middle-class background, into the market, encouraging them to purchase, first, railroad bonds, then industrial preferred stock, and ultimately common stock. By the middle of the second decade of the twentieth century, the makings of the bull market of the 1920s were all in place, assisted by the Liberty Bond drives of 1917 and 1918 and growing brokerage houses that convinced investors to turn their

attention from bonds to common stock. A new class of public, passive investors emerged (L. Mitchell 2007).

This new class had little effect on corporate affairs. Doctrinal changes, including the erosion of the ultra vires doctrine, the reintroduction of the idea that the board's power was original and undelegated, and the elimination of the shareholders' right to remove directors at will, helped minimize shareholder control. So too did changing voting rules. Proxy voting became the norm and states gradually adopted statutes allowing a simple majority of the shareholders to approve the sale of corporate assets, abolishing the nineteenth-century rule of unanimity. The newly legalized holding company further undermined shareholders' power, allowing one corporation to control the majority of stock of many direct and indirect subsidiaries through pyramiding. Limitations on the voting rights of certain classes of shareholders, including non-voting stock and conditional voting stock, also became common in the first decades of the twentieth century (Horwitz 1992; D. Mitchell 2006).

Moreover, while share ownership became more dispersed and businesses grew in size, their control became concentrated. In 1913, the report of the Pujo (Banking and Currency) Committee confirmed the existence of a money trust, consisting of a small number of financiers sitting on multiple corporate boards, who controlled the economy with the assistance of the New York Stock Exchange that allowed practices such as pools to the detriment of working- and middle-class individual investors (Ott 2011). In 1932, *The Modern Corporation and Private Property*—modern corporate law's foundational text—documented how some 200 corporations, controlled by less than 1800 men, administered over one-third of the national wealth (Berle and Means 1932).

The concentration of power in large business corporations and the development of the modern stock market undermined traditional understandings of economic and political markets. Progressives worried that corporations were wearing away the function of the individual producer and with it the idea that markets could equitably allocate the rewards of individual effort and align individual liberty with socially favorable goals (Zacharias 1988).

Seeking to sustain the nineteenth-century ideals of civic engagement and to add organization, stability, and reason to what seemed to be the chaotic nature of industrial capitalism, Progressives offered different solutions to the problem of the growing corporations. Some emphasized the need to control business units locally in order to encourage civic participation and to keep corporate power in check. Others wanted to subject large corporations and their power to national regulation. Still others turned to a new way of thinking about political economy—

consumerism. They wanted Americans to confront big business and centralized markets not with the tools of local or national regulation but as enlightened consumers (Pells 1973; Sandel 1996).

After the 1929 market crash painfully brought light onto inadequate corporate reporting, managements manipulating insider information, faulty credit control, and the frenzied speculation that characterized the 1920s (H.R. Rep. No. 73-1383 (1934)), proponents of nationalization, decentralization, and consumerism converged on mandatory disclosure as the ultimate regulatory tool. They refrained from restricting organizations' power and focused instead on ensuring that information was readily available to individual investors—indeed, the consumers—as potential regulators (D. Mitchell 2006). The Securities Acts of 1933 and 1934 reflected the idea that federal legislation should be limited to requiring "full and fair disclosure of the nature of the security being offered and that there should be no authority to pass upon the investment quality of the security" (Seligman 1982, 63).

The Securities Acts balanced decentralization with national planning and consumerism. The 1933 Act embraced the view that modern business and finance could be regulated through the combination of flexible national administration, existing state regulation, and individual investment choices. The 1934 Act focused on the registration of the stock exchanges and the requirement that firms traded on these exchanges file annual and quarterly reports with a newly established agency, which the act created—the Securities and Exchange Commission (SEC). The act further prohibited certain manipulative devices such as short selling, and regulated insider trading (De Bedts 1964; Parrish 1970).

* * *

With the securities acts regulating the market, corporate legal scholars turned to the power that corporations could exercise over individuals and groups, internally and externally. They wanted to use corporate law to supplement federal regulation by imposing stringent fiduciary duties on corporate managers (and controlling shareholders). Federal regulation would impose "market-improving rules" *ex ante* in an attempt to equalize the power of individual investors and the control group and allow small investors freely to participate in the securities markets. Corporate law would *ex post* use trust to "remedy managerial abuses of [such investors] as they occurred" (Kaufman & Zacharias 1992, 538).

In the 1920s, reformers' attention focused on the concentration of corporate control in the hands of a few investment bankers and controlling shareholders (and, to a more limited extent, management). Legal

scholars wanted to constrain the control group's ability to harm, through its participation in corporate management or through market manipulation, the individual, unsophisticated shareholder. While they did not necessarily envision shareholders actively participating in (and helping control) corporate management, Progressive jurists believed in the potential effectiveness of fiduciary obligations as a regulatory tool. They wanted directors to act as trustees for their corporation's shareholders (D. Mitchell 2006).

Trust was the Progressive jurists' working rule, regulating corporations where private bargains failed (Kaufman and Zacharias 1992). Take, for example, Adolf Berle's "Corporate Powers as Powers in Trust" (1931), an article that examined five important powers (of corporate directors) that Berle wished to subject to fiduciary obligations. First was the power to issue stock, which Berle wanted to "subject to the equitable limitation that such issue must be so accomplished as to protect the ratable interest of existing and prospective shareholders" (1050). Second was "the power to declare or withhold dividends," which, as Berle argued, had to be used so as to benefit all shareholders rather than one class or group of shareholders (1060). Third was "the power to acquire stock in other corporations." Berle wanted to guarantee that such power would not be used "to forward the enterprises of the managers as individuals or to subserve special interests within or without the corporation" (1063). Fourth was "the reserved power of the corporation to amend its charter." Berle argued that such power had to "be so exercised that the result will tend to benefit the corporation as a whole, and to distribute equitably the benefit or the sacrifice, as the case may be, between all the groups in the corporation as their interests may appear" (1066). Fifth was "the power to transfer the corporate enterprise to another enterprise by merger, exchange of stock, sale of assets or otherwise." Berle wanted to guarantee that the interests of all classes of shares were "respectively recognized and substantially protected" in such transactions (1069).

The courts considered the powers Berle enumerated a matter of contract law, susceptible to statutory changes (and the possibility of opting out). Berle was concerned that existing corporate statutes—especially the Delaware statute, "whose drafting and enactment [Berle] attributed to powerful New York business lawyers—gave managers extremely broad power without accompanying statutory limitations" (Strine et al. 2010, 642). Berle wanted to make these powers a matter of the directors' trusteeship duties. He used shareholders' disempowerment to impose fiduciary duties on management and the control group. As Judge Cardozo put it in *Meinhard* v. *Salmon* (1928), trust was not

grounded in the market place, in contract (or even in statute); it was not "honesty alone, but the punctilio of an honor the most sensitive" (546).

While the idea that directors' obligations ran to the shareholders (to the exclusion of other corporate constituencies) would ultimately come to dominate corporate law, the idea that directors were trustees for the community carried great weight in the 1930s, articulated most memorably by E. Merrick Dodd in response to Berle's article (Dodd 1932). This vision, which Berle, too, endorsed in *The Modern Corporation and Private Property*, reached back to the Progressives' emphasis on the civic responsibilities of the elite class and to the Progressives' pragmatic description of corporations as real entities—with multiple owners, complex financial structure, managerial control, immortality, and power. Given corporations' economic power, Progressive jurists argued that it was meaningless to assume that corporations were private associations, or that the state was the only center of coercive (public) power. Corporate power was "comparable to the concentration of religious power in the medieval church or of political power in the national state" (Berle and Means 1932, 352; D. Mitchell 2003).

Because corporations were centers of power resembling sovereign power, Progressives and New Dealers wanted corporate power to be exercised in trust for the community. Seeking to legitimate the large public corporation and its power while eliminating potential abuses by the control group, scholars vested corporations with public power and public trust. For a short while, the real entity vision of the corporation, coupled with the description of corporations as trustees for the community, prevailed. The success of the modern American state demanded recognition of the large corporation's autonomy as well as limitations on its power. Neither the shareholders nor the controlling group could deny this premise. Corporations were free to exercise their power—in trust for the community under the watch of law (Berle and Means 1932; D. Mitchell 2003).

The business community was quick to coopt this concept of trust. Owen D. Young, chairman of General Electric during the 1920s and 1930s, stressed, for example, that business managers were trustees for the public who needed little if any supervision from the states or the federal government. While the business community "would not fully live up to Young's expectations … it did take advantage of Young's trustee argument." In *Fortune* magazine articles and in statements by the Committee for Economic Development and the Business Roundtable "managers represented themselves through Young's model" (Kaufman and Zacharias 1992, 527).

Progressive legal scholars viewed trust as a flexible standard that courts could apply to resolve complex conflicts. But the influence of trust on the reality of directors' duties was in the end limited. Partially because scholars offered different visions as to whom directors were trustees and provided no concrete plan as to how the idea of trust would be implemented, partially because the business community used the concept of trust to promote its own agenda, partially because courts have struggled at least since the mid-nineteenth century to define the role of the board of directors, the idea that directors were trustees for shareholders or the community was quickly replaced by the idea that directors were the shareholders' representatives.

The significance of the Berle-Dodd exchange, referenced above, lay indeed not in the differences of opinion between Berle and Dodd but in their agreement. The exchange was the swan song of the early-twentieth century attempts to use trust as a means of regulating corporations and the control group. Beginning in the late 1930s, discussions of directors' duties focused not on corporate power or market manipulation but on corporate hierarchies. As the following part explores, in this context directors were described as the shareholders' representatives while business judgment and fairness became the standards of review applicable to claims of breaches of the duty of care and the duty of loyalty, respectively. A vision of a harmonious relationship between corporations and society, captured in the term "corporate democracy," substantiated this transformation.

II. DEMOCRACY, EXPERTISE AND FAIRNESS—1940s–1970s

The fears that led scholars to embrace trust as their working rule dissipated by the late 1930s. Early New Deal programs, which were focused on the collaboration between government and business, seemed to circumscribe the corporation's powers (Hovenkamp 1988). In regulating the corporation's dealings with its shareholders and its creditors, the Securities Acts in particular alleviated earlier concerns about market manipulation (De Bedts 1964).

After the unanticipated economic recession of 1937, New Dealers began to reassess their vision of the modern administrative state. Some advocated the expansion of the regulatory state and called on the federal government more effectively to defend consumers and promote full production. Others did not want the state to coordinate economic activity but merely to redress "weaknesses and imbalances in the private

economy without directly confronting the internal workings of capitalism." The state was to "manage the economy without managing the institutions of the economy" (Brinkley 1989, 87–97). With totalitarianism in Europe, and scholars' growing concerns about the relationship between statism and tyranny, the compensatory vision of the state prevailed. A vision of a free market, compensated by the state's fiscal hand on rare occasions, began to dominate economic thought (Brinkley 1989 and 1995; Sandel 1996).

At the same time, the Second World War helped improve the public image of corporations and their managements. The growth of new industries (i.e., electronics and communications) eliminated corporate debt, allowed corporations to cut prices, and introduced new management techniques. It also encouraged large corporations to take over government responsibilities. Corporations were embraced as dominant economic, social, and political institutions. The concerns and the reformist zeal of earlier decades were forgotten as the war effort strengthened the alliance between corporations and the federal government (Beatty 2001). Rather than being viewed as in conflict with the American polity, corporations became its quintessential institution. Gradually, American liberalism was being adapted into American corporate capitalism.

Business was at the forefront of change. Business leaders ardently used public relations campaigns to advertise their corporations' contributions to the war effort and freedom, making the preservation of free enterprise indispensible to the nation's survival and success. The early New Deal programs (and government regulation) were characterized as regimented, if not directly similar to the policies of authoritarian regimes. Freedom of enterprise was signaled out as ensuring America's strength and future (Marchand 1998).

The publicly held corporation also did not live up to the "horrifying billing" that it got during the turn of the twentieth century and instead had become associated with efficient industries that provided occupational opportunities and a good medium for social mobility. A sharp rise in mass standards of living that occurred during the first half of the twentieth century was attributed to the dominance of large business corporations while other countervailing big entities gained negative estimation (Hofstadter 1965, 212–15; Beatty 2001). For one thing, as organized labor grew larger and more bureaucratic, on a par with business, labor leadership (and sometimes the government) were blamed "to a much greater degree than industrial management for delays in war production" (Marchand 1998, 358). The fear of gigantic corporate entities that would ruin society had disappeared. The early twentieth century's oscillation between "love of bigness and efficiency" and "fear

of power and … regard for individualism and competition" came to a halt in favor of large business corporations (Hofstadter 1965, 212–13).

In 1946, Peter Drucker declared that the question "to have Big Business or not" was "meaningless if not frivolous." Like many of his contemporaries, Drucker believed that the American ideal of democracy had to adapt to the modern industrial order that was, in turn, dependent for its success on "big business organization—that is large, integrated plants using mass-production methods." The corporation was not merely an economic organization but "America's representative social institution." As such, it had to fulfill "the aspirations and beliefs of the American people" (Drucker 1946, 5–14).

As business scholars saw it, corporations were to be managed by a multiplicity of loyal leaders, "men of ability and initiative" capable of fighting or evading "bureaucratic ossification and bureaucratic timidity" and pursuing corporate policy. Managers had to "subordinate individual ambitions and decisions to the needs of the corporation's welfare and survival." Drawing on his study of General Motors, Drucker concluded that corporations should combine "corporate unity" with "divisional autonomy and responsibility," and aim to realize "unity through local self-government and *vice versa*." Senior managers were viewed as capable of balancing the different needs of the corporation's various divisions and constituencies (Drucker 1946, 33–46; Wells 2002). The term "free enterprise"—in use since the 1930s—came to symbolize the free reign of managers, who in the cultural imagination replaced the small producers and entrepreneurs of the nineteenth century (Drucker 1953; D. Mitchell 2003).

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The ideals of bureaucratic expertise and managerialism were substantiated by the discourse of democracy that came to dominate the midcentury discussions about the role of the board of directors and American political and legal theory more broadly. Beginning in the 1940s, social scientists used the democratic ideal to explain why America had been spared the ravages of European totalitarianism (Purcell 1973). Influenced by these discussions, corporate legal scholars used the concept of representative democracy both to rationalize managers' power to run their corporations and to assure shareholders that their interests were protected.

Managers (directors and officers) were described as the shareholders' representatives who, while "not amenable to direct shareholder control, nevertheless serve shareholder interests." The "shareholder interest" was not determined by reference to shareholders' subjective, and potentially

conflicting, desires. Rather, it was an "objectified abstraction," determined by the fiduciaries, "the bureaucratic managers," and "attributed to all shareholders of all corporations whether they want it or not." Management had full discretion to determine the "shareholder interest" while "shareholder interest" presumably constrained management's power. By relying on this circularity of power and restraint, courts helped legitimate corporate and management power in the second part of the twentieth century (Frug 1984, 1307–9).

In midcentury, New York was the leading jurisdiction developing the duties of directors as representatives. The courts' tools were an exemption from liability for honest mistakes (mistakes that even a prudent person might make) from which directors benefited throughout the nineteenth century and the novel (in corporate law) concept of fairness. Expanding the scope of the exemption for honest mistakes to encompass all directors' errors, NY courts created the modern business judgment rule as a rule of deference to directors' expert opinion. Subsumed under this rule, the tort (negligence)-based duty of care became the limited requirement that directors not act recklessly or in a gross negligent manner (D. Mitchell 2009). At the same time, the courts transformed the duty of loyalty from a duty grounded in utmost trust and honor to the limited requirement that directors' and officers' actions do not unfairly disadvantage their corporation (L. Mitchell and D. Mitchell 2010).

Take, for example, *Litwin* v. *Allen* (1940), a case involving allegations of breaches of the duty of loyalty as well as negligence. The allegations focused on a sale of Missouri Pacific's debentures. Alleghany Corporation, the seller and Missouri Pacific's parent company, contracted for a "call" option that allowed it to buy the bonds back at the price paid during the first six months of the deal. Guaranty Trust Company, the buyer, failed to contract for a "put" option to ensure against decline in the debentures' price. When, shortly thereafter the latter happened, Guaranty Trust's shareholders brought a derivative suit alleging that its directors breached their duty of care.

Justice Shientag of the Supreme Court of New York, Special Term appeared unequivocal, stressing that in addition to undivided loyalty and good faith, directors had to exercise some degree of skill, prudence, and diligence. While directors were not liable for "errors of judgment or for mistakes while acting with reasonable skill and prudence," they were "liable for negligence in the performance of their duties" (677–8). Reflecting "the propensity of post-Depression courts to require a higher standard of care for bank directors than nonbank directors," Shientag held the directors of Guaranty Trust, a financial institution, negligent and thus liable for breach of the duty of care (Macey and O'Hara 2003, 101;

McCoy 1996). Yet, even with respect to bank directors, Shientag stressed: "the law recognizes that the most conservative director is not infallible, and that he will make mistakes." So long as a director used "that degree of care ordinarily exercised by prudent bankers he will be absolved from liability although his opinion may turn out to have been mistaken and his judgment faulty" (678).

Gradually, exemptions to directors' liability encroached upon the standard of care applicable to their actions. As Shientag noted in *Bayer* v. *Beran* (1944), "although the concept of 'responsibility' is firmly fixed in the law, it is only in a most unusual and extraordinary case that directors are held liable for negligence in the absence of fraud, or improper motive, or personal interest" (6). The presumption of the business judgment rule was transformed from an exemption into a rule of complete deference, a substitute for the duty of care. In the absence of fraud, conflict of interest, or bad faith, courts refrained from evaluating directors' actions even when the directors' errors were gross. Shareholders, who were already precluded from instructing their representative directors as to how to manage the corporation, were now also mostly prevented from challenging directors' decisions even if they harmed the corporation. As Robert A. Kessler concluded in a 1960s article, in a majority of jurisdictions, the board was regarded as "a kind of a group of Platonic guardians whose right to rule was a legislative mandate" (Kessler 1960, 697; D. Mitchell 2009).

Viewing directors as representatives, courts also turned to the concept of fairness to replace earlier notions of trust as the foundation of the duty of loyalty. The difference between trust and fairness was significant. A trust standard of review required voiding transactions between the corporation and a director or an officer simply because they involved the self-interest of the latter. In turn, the fairness standard of review allowed courts to validate transactions, even though they were the result of breach of trust, that is, they involved the self-interest of the fiduciary, if the result of such transactions was fair, that is, resembling the result of a transaction entered in a "trustworthy manner" (L. Mitchell 1993, 435).

Compare *Globe Woolen Co.* v. *Utica Gas and Electric Co.* (1918), a case involving contracts between two companies sharing a common director, with *Everett* v. *Phillips* (1942), a case involving a loan transaction between two companies with common directors, Long Island Lighting Corporation and Empire Power Corporation.

In *Globe Woolen*, despite the fact that the common director did not vote to adopt the contracts, Judge Cardozo annulled them, holding directors to "the duty of constant and unqualified fidelity." Withdrawing from the vote or dealing did not meet such heightened requirements.

Rather, "the constant duty rests on a trustee … to protest and renounce if through the blindness of those who treat with him he gains what is unfair." The common director had an affirmative obligation to disclose the unfair advantage to the disadvantaged corporation (489–92).

Two decades later, in *Everett*, Judge Lehman noted that the dual position of the directors, while "making the unprejudiced exercise of judgment by them more difficult," did not in itself "suffice to render the transactions void." That the Power Corporation had a provision in its charter "expressly authorizing the directors to act even in matters where they have dual interests" exonerated "the directors, at least in part, 'from adverse inferences which might otherwise be drawn against them.'" And while the evidence demonstrated that the directors thought the loans promoted the Lighting Corporation's interests, nothing in the evidence showed that they did not also think that the loans would promote the interests of the Power Corporation and its stockholders. Given the charter provision and the lack of evidence to the contrary, the contracts were held valid (*Everett*, 236–7).

As investors became multiple and passive, entrusting corporate directors and officers with the administration of their collective property, the courts seemed to undermine the investors' ability to trust their managers. But the courts' rhetoric assured investors that their trust was not misguided. The doctrinal changes were described as minimal—rather than viewing directors as trustees who were required to sacrifice their interest for the benefit of the corporation, courts depicted directors as trustworthy representatives, capable of expert management and entitled to having the interests of their corporations and their shareholders balanced against their own.

The Delaware courts similarly embraced business judgment and fairness as appropriate standards of review in cases involving allegations of breaches of the duty of care and the duty of loyalty, respectively. Yet, no clear definition of what care or loyalty meant existed in Delaware until the 1980s. As the following part explores, by then, the introduction of the monitoring model of the board and the embrace of the economic theory of the firm helped ensure that both standards of review would focus on the processes through which decisions and transactions were approved rather than on their substance.

III. PROCESS, MARKETS, AND FINANCE: 1970s–1990s

The 1970s brought a renewed interest in the practices of corporate management. Amidst social and political upheaval, public-interest

shareholder groups used the SEC's proxy and shareholder proposal rules to address corporate practices related to the Vietnam War, environmental protection, occupational safety, and equal employment. Institutional investors became important players in corporate governance, raising new questions about the control of corporate America. Several corporate bankruptcies, including the unexpected collapse of Penn Central, raised grave doubts about their boards' performance, while corporate scandals involving illegal political contributions revealed during the Watergate investigation exacerbated such doubts (Seligman 1987).

Studies concluded that boards of directors of large and medium-sized corporations were no longer a significant check on the CEO; they did not even have much say in selecting the executives because management controlled the proxy machinery. Outside directors were ineffective. They were typically chosen from the same social networks as the top executives and sitting with the latter on several boards; they were thus unlikely to challenge the executives. Studies further revealed that most boards did not meet frequently enough to perform a meaningful role (Seligman 1987).

Proposals for reform followed, converging on the monitoring model of the board. It described directors as monitors of management and recommended that boards include a significant number of outside directors (Seligman 1987). This model was strengthened with the 1982 publication of the draft of the American Law Institute's *Principles of Corporate Governance* (the final version was published in 1994 after a decade-long heated debate). But consensus was limited to the role independent directors should play in reviewing the activities of the executives. What that meant as far as directors' duties, and to whom directors owed them, remained contested issues throughout the 1980s (L. Mitchell 2010).

While some legal scholars wanted to use the monitoring model substantially to redefine directors' duties, corporate lawyers and business groups were strongly opposed to any attempt to tinker with the limited directorial duties. They focused on the monitoring role of non-management directors and suggested that good boards contain a majority of them. Directors were not to be representatives of different corporate constituencies; their monitoring powers were meant to promote share-price maximization (L. Mitchell 2010). It was not long before the business community's emphasis on independent oversight influenced the courts' analysis of directors' duties and the business judgment rule, turning substantive duties into procedural ones.

Beginning in the 1980s, the Delaware courts, fully embracing the monitoring model of the board as a structural rather than substantive one, focused on the role of independent directors. First, the Delaware courts

collapsed the duty of care into the business judgment rule while also equating the latter with the duty to be informed. Without definite precedent to support their announcement, the courts further proclaimed that the business judgment rule altered the standard of care from negligence to gross negligence (*Aronson* v. *Lewis* 1984). Unless a plaintiff arguing a breach of the duty of care demonstrated that the directors were grossly negligent (with respect to the requirement to be informed), the presumption of the business judgment rule would attach to the directors' decisions and the court would not second-guess their actions. A rule of deference to expert opinion had become a defense precluding judicial inquiry into the directors' challenged actions. If up to the 1980s directors might have been held liable for violations of the duty of care (although they seldom were) by the end of the decade such possibility was implausible (D. Mitchell 2009).

The duty of loyalty, too, was quickly eroded. First came board decisions to adopt defensive tactics against hostile takeover bids. Despite the specter of conflict of interest that such decisions involved, the Delaware Supreme Court did not apply the fairness standard of review. In *Unocal Corp. v. Mesa Petroleum Co.* (1985), the seminal takeover case, the court adopted a more lenient test—a two-prong test that assessed whether the directors "had reasonable grounds for believing that a danger to corporate policy and effectiveness existed" and whether the defensive tactic the board adopted was "reasonable in relation to the threat posed" (955). Thereafter, the Delaware courts emphasized that if a majority of independent, disinterested directors, following procedural requirements, approved the tactic under review, the board's action would likely meet the burden of the *Unocal* test (D. Mitchell 2009; L. Mitchell 2010).

The hostile takeover cases raised novel questions involving complex transactions and strict time limits. Insisting on a lengthy fairness analysis could have had a detrimental impact on the corporations involved and their investors. But the Delaware courts' embrace of the independent directors' protective effect reached further—to all cases addressing allegations of breaches of the duty of loyalty. Gradually, the courts shifted attention away from the substance of the transactions to the procedures directors pursued to negotiate and effectuate them.

Take, for example, self-dealing transactions. In the 1940s, the courts examined such transactions using a fairness analysis that focused on the transaction's value to the corporation. In the late twentieth century, courts turned to section 144 of the Delaware General Corporation Law (DGCL) to create a procedural "safe harbor" for such transactions. On its face, section 144 (adopted in 1967) rescues self-dealing transactions from *per se* voidability (Rohrbacher et al. 2008). The courts, however, used the

provision to validate transactions that were authorized by an informed vote of a majority of the disinterested directors (*Benihana of Tokyo, Inc.* v. *Benihana* 2006). In tandem, the courts turned fairness from a substantive standard of review, focusing on the transaction's benefits to the corporation, into a procedural one, focusing on the ways in which the transaction was approved.

Similarly, when addressing parent-subsidiary cash-out mergers, the Delaware courts moved away from evaluating the fairness both of the transaction's negotiation and approval processes and of its price to ensuring that the transaction was authorized by the disinterested directors and ratified by the disinterested shareholders. Reliance on both procedures brought the transaction under the presumption of the business judgment rule and eliminated the need to inquire into its fairness. Entire fairness, the court stressed in *Kahn* v. *M&F Worldwide Corporation* (2014) was "the highest standard of review in corporate law", hence, it applied only as "a substitute for the dual statutory protections of disinterested board and stockholder approval" (645). Procedural fairness became the norm and substantive fairness the exception.

* * *

Why, then, should shareholders continue to trust their corporate managers? Neoclassical economics and modern finance theory, in vogue since the 1960s, helped legitimize the courts' transformation of fiduciary obligations into predictable processes, ultimately paving the path for the Delaware courts' final move—away from business judgment and fairness toward good faith as a catchall standard of review for directors' and officers' decisions and actions.

Beginning in the 1960s, neo-classical economists, who had until then focused their theorizing efforts on markets, turned to the corporation's internal structure offering a picture of the corporation that fitted the market-centered economic policies of the postwar years. Rather than putting management hierarchies or the need to constrain corporate power at the center of the corporate paradigm, neoclassical economists drew on microeconomics to paint a picture of the corporation as a nexus of private, contractual relationships. The corporation was a collection of "disaggregated but interrelated transactions" among individuals or the convenient fiction of corporate entity in free and efficient markets (Bratton 1989b, 420).

Following directly from this new theory of the firm was the idea that "the relationship between the stockholders and managers of the corporation" was "a pure agency relationship" (Jensen and Meckling 1976,

309). Drawing upon this concept of agency, corporate legal scholars were able to turn the century-old separation of ownership from control from a problem that in the early twentieth century justified viewing directors as trustees to an efficiency producing solution that at the century's end legitimated limiting directors' duties.

Law and economics scholars proclaimed that all actors in the corporate endeavor preferred separating ownership from control. Investors were not only "free to choose," but also presented with "rich and diverse choices." They supplied capital "because they [had] sufficient savings they [were] willing to entrust to the managerial skills of others, in return for a share in the resulting profits" (Hessen 1983, 285–9). Investors chose to be passive because it allowed them to maximize profits. They were also presumably able to protect their interests contractually and, if needed, they could become active—through takeovers, proxy fights, and purchase of control (Demsetz 1983).

Separating ownership from control was an efficient choice for investors. As law and economics scholars saw it, organizational forms survived because of the "comparative advantages of characteristics of residual claims in controlling the agency problems" (Fama and Jensen 1983a, 345). By separating "the ratification and monitoring of decisions from initiation and implementation of decisions," the "contract structure" of the modern corporation effectively controlled "the agency problems caused by separation of decision and risk-bearing functions" (Fama and Jensen 1983b, 302).

Once the separation of ownership from control was deemed efficient, self-interested shareholders were presumed to discipline corporate managers, their agents, through their market power (Demsetz 1983). The firm's contracts were supposed ("priced") to take management self-interest, including excessive self-dealing, into account, and the legal community could assume that if the shareholders did not accept certain behavior, it would become too costly and disappear. Not even a supplemental legal regime of fiduciary duties was necessary (Bratton 1989a).

Modern finance theory pushed the argument further. In the first part of the twentieth century, as corporations sought to create a market for their stock, economists justified investment by reference to the intrinsic value of corporations. Investors were advised to rely on fundamental valuation to assemble a portfolio of carefully selected diversified stock. Advice was different in the second half of the century. In the 1950s, Harry Markowitz's portfolio theory suggested that investors could create "an efficient portfolio" that would achieve maximum return for any level of preferred risk by diversifying non-systematic risks. The portfolio, rather than individual corporations, became the focus of analysis. In the mid-1960s,

William Sharpe and John Lintner's Capital Asset Pricing Model (CAPM) indicated that even systematic risks that affect the market as a whole could be "diversified away." Rather than study the fundamentals of companies, investors were told to study the historical performance of these companies' stock price in relation to the market (L. Mitchell 2009, 176–9).

The Delaware courts wholeheartedly embraced CAPM. Shareholders, Chancellor Allen wrote in *Gagliardi* v. *TriFoods International, Inc.* (1996), "can diversify the risks of their corporate investments." Their "economic interests" are thus maximized "if corporate directors and managers honestly assess risk and reward and accept for the corporation the highest risk adjusted returns available that are above the firm's cost of capital." It was thus "in the shareholders' economic interest to offer sufficient protection to directors from liability" so that directors knew that "if they act in good faith and meet minimal proceduralist standards of attention," they would not face liability. Finance, in short, justified shielding directors from liability (1051).

The rapid growth in institutional investors' stock ownership substantiated the shareholders' ability to protect themselves. Institutional investors, such as mutual funds, provided the most common form of diversification for individuals with modest means. Institutional investors were also presumed to be more active and more willing to press corporate managers. "Market developments … have made it far easier, not harder, for stockholders to protect themselves," then Chancellor Strine wrote in *Kahn* v. *M&F Worldwide Corporation* (2014). The development of the Internet has made public information more readily available, including analysts' and institutional investors' views about proposed corporate transactions. And these institutional investors have also made it easier "for a blocking position of minority investors to be assembled" (531).

The courts continued to emphasize the importance of the business judgment rule and procedural fairness. Yet, not only did they allow directors (as agents) to act against the expressed wishes of their shareholders (especially in cases involving mergers and acquisitions), the courts also gradually substituted the standard of good faith for business judgment and fairness. Fiduciary duties were rapidly reduced into the minimal requirement that directors, acting in (subjective) good faith, follow token procedures.

Resting on the assumption that shareholders, as principals, elected directors, as agents, to represent their interests, good faith could have filled the gap the Delaware courts created by obliterating the duty of care and by equating the duty of loyalty with procedural fairness. Yet, as the

following part elaborates, the Delaware courts chose differently. While stressing that all directors' and officers' actions became conditioned upon the requirement that they "have been undertaken in good faith to advance the interests of the corporation and its stockholders" (Strine et al. 2010, 643), the courts held that to demonstrate lack of good faith, a plaintiff shareholder had to demonstrate "that the directors acted with scienter, *i.e*., that they had 'actual or constructive knowledge' that their conduct was legally improper" (*In re Citigroup* 2009, 125). So long as directors subjectively believed that they fulfilled their obligations, the courts were not likely to evaluate their actions (or lack thereof). All that was left of fiduciary obligations was a promise to the shareholders that their corporations' directors and officers were their faithful agents.

IV. GOOD FAITH: A 21st CENTURY APPROACH

Good faith became the focus of judicial decisions in the 1990s after, in response to *Smith v. Van Gorkom* (1985), a case that shocked both the legal and business communities by holding directors liable for breach of the duty of care, the Delaware legislature enacted section 102(b)(7) of the DGCL. The section allows corporations to include in their charters provisions that limit, or even eliminate, the personal liability of directors for monetary damages for breaches of the duty of care. Left out of section 102(b)(7)'s reach are breaches of the duty of loyalty and actions not in good faith. Given the limited reach of the former, it was not long before the Delaware courts had to reckon with the definition of good faith. As they did, they reduced directors' fiduciary obligations to a bare minimum.

Cede & Co. v. *Technicolor, Inc.* (1993) was among the first cases to draw attention to the duty of good faith. Addressing the plaintiff's allegations that the Technicolor board breached its duties of care and loyalty in negotiating and effectuating a merger transaction the Supreme Court of Delaware declared that corporate directors owe a "*triad*[]" of fiduciary duties—"good faith, loyalty [and] due care" (361).

In re Caremark International Inc. Derivative Litigation (1996) offered Chancellor Allen an opportunity to define good faith. Addressing the plaintiffs' claims that Caremark suffered losses as a result of the board's failure to monitor Caremark's officers and employees, Allen stressed that boards had an affirmative duty to ensure systematic monitoring. A heightened standard of conduct was coupled, however, with a minimal standard of review. So long as the board exercised "a good faith judgment" as to the adequacy of the corporation's information and

reporting system, Allen held, it could not be held liable for the system's failure to reveal violations of law or duties by officers or employees (967–71). The substance of the board's decision was not subject to review. The court was only required to determine that the process in which a compliance system was adopted "was either rational or employed in a *good faith* effort to advance corporate interests" (967). In a memorable quote Allen held: "only a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition to liability" (971). The directors' duty to monitor became largely inconsequential.

In re Walt Disney Co. Derivative Litigation (2006) followed. The key question in the case was whether Disney's directors breached their duties by hiring Michael Ovitz as president and firing him 14 months' later with a severance package of roughly $130 million. Disney's charter exempted directors from liability for breaches of the duty of care pursuant to section 102(b)(7) of the DGCL. Resurrecting a separate duty to act in good faith was the only means of imposing liability on the board of directors. Chancellor Chandler was skillful in crafting the duty and the Delaware Supreme Court affirmed. According to *Disney*, a director might fail to act in good faith if he "intentionally acts with a purpose other than that of advancing the best interests of the corporation … acts with the intent to violate applicable positive law, or … intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties" (67). The latter possibility was particularly pertinent in *Disney* but Chancellor Chandler determined that, while they did not follow best corporate practices, the Disney directors did not fail to fulfill their duties. The Supreme Court of Delaware affirmed.

Stone v. *Ritter* (2006) carried on. Addressing the plaintiffs' "classic *Caremark* claim," Justice Holland reiterated good faith's subjective nature. A plaintiff would have to prove subjective bad faith to demonstrate the liability of an independent director. "Evidence of gross or inextricable sloppiness remained relevant to that scienter determination, but it was only evidence, and not a substitute for a director-specific determination of an illicit state of mind" (Strine et al. 2010, 693). Justice Holland admitted that the test of liability upheld in *Stone* was "quite high." In *Stone*, while the reporting system was insufficient and ineffective, the plaintiff shareholder failed to prove that the directors consciously disregarded their duty to monitor. Yet, quoting *Caremark*, Holland stressed that the high bar was in the shareholders' best interests: in making "board service by qualified persons more likely, while continuing to act as a stimulus to *good faith performance of duty* by such

directors[,]" it ensured that shareholders would continue to profit (*Stone* v. *Ritter*, 372). In this vein, the obligation to act in good faith also did not establish an independent fiduciary duty. Rather, it was "a condition, 'of the fundamental duty of loyalty'" (369–70).

Stone betrayed long-standing precedent, including *Caremark*, that treated the duty to monitor as a tort duty. It further betrayed *Disney* that treated good faith as an independent duty. Nonetheless, the Delaware community endorsed *Stone*'s characterization of good faith. In a co-authored article, then Vice Chancellor Strine declared that the duty of good faith had "long been used as the key element in defining the state of mind that must motivate a loyal fiduciary." *Stone*, accordingly, was a "mundane and unsurprising decision," simply reiterating the already known—that "the duty of loyalty … [is] … central to Delaware's approach to corporate law" (Strine et al. 2010, 633).

Viewed as a subcategory of the duty of loyalty, good faith unified the analysis of directors' and officers' fiduciary obligations. The duty of loyalty had become a duty "implicated by all directors actions because all such actions must be undertaken in good faith to advance the corporation's best interests and because directors owe an affirmative obligation to put in a good faith effort to responsibly carry out their duties." The duty of care was subsumed by the duty of loyalty. "So long as a fiduciary made a good faith effort to exercise care, that was all that the stockholders could reasonably expect" (Strine et al. 2010, 634–6). So long as directors acted in (subjective) good faith, their actions were likely to pass muster under Delaware law.

Treating good faith as an independent duty would have provided an opportunity to impose liability on directors, especially independent directors, in cases ranging from monitoring to mergers to hostile takeovers to self-dealing transactions. But the Delaware courts, concerned about subjecting corporate directors to liability, refused to seize the opportunity. Instead, the courts used the rhetoric of good faith to define an extremely narrow standard of review, negating the possibility that directors and officers would be found to have acted in bad faith.

The story of the modern jurisprudence of directors' duties, as told in this chapter, began with trust, continued with business judgment and fairness, and ended with good faith. Trust as a standard of review emerged out of the early twentieth century's fears about the rapidly growing publicly held corporations. In midcentury, a period during which corporate law scholars came to accept corporations as critical for America's survival and success, business judgment and fairness developed as a means of ensuring balance and harmony. The rhetoric of good faith came into fashion in an intellectual milieu that viewed the securities

market as the most effective institution to constrain corporate management. Without fears or need for balance, law's role was reduced to assuring investors that their trust in their corporate managers was justified while also enabling the free reign of powerful managers unrestrained by law.

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20. Adolf Berle, E. Merrick Dodd and the new American corporatism of 1932

William W. Bratton and Michael L. Wachter

1. INTRODUCTION

Corporate law scholars engage in a continuing debate among those who favor shareholder primacy, those who favor management discretion, and those who believe that corporations have a social responsibility to other constituencies, such as the corporation's employees, and the wider public interest. Although the battle lines wax and wane, shareholder primacy prevails today as the dominant view, with management discretion advocates in the minority, and with advocates of corporate social responsibility as a rearguard. Many discussants think of themselves as picking up where Adolf A. Berle, Jr. and E. Merrick Dodd left off in their famous, precedent-setting debate of 1932 (Fisch 2006: 646; Wells 2002: 81). The widely-accepted historical picture puts Berle in the position of being the grandfather of shareholder primacy (Bainbridge 2003: 561; Stout 2002: 1189). Dodd, on the other hand, tends to be cast as the original ancestor of corporate social responsibility ("CSR") (Matheson and Olsen 1992: 1330; Winkler 2004: 115–16). But other observers see things differently. Some modern writers introduce a conflicting characterization, looking to Berle as a CSR ancestor (Millon 1990: 222). Compounding the confusion, Dodd also is read in different ways. Although most align him with modern CSR, others see him more as an advocate for management discretion, with social responsibility as just another area inside the zone of business judgment. Berle (1962: 442–3) himself made the latter characterization of Dodd, as do a small number of modern writers (Mitchell 2001: 186–7; Joo 2004: 353).

This chapter displaces all these interpretations of Berle and Dodd, drawing on two earlier papers (Bratton and Wachter 2008, Bratton and Wachter 2010), which we believe set forth what are now taken as the state-of-the-art readings of these fundamental texts: Berle's (1931) article, "Corporate Powers as Powers in Trust," Dodd's (1932) response, "For Whom Are Corporate Managers Trustees?," Berle's (1932) subsequent rebuttal, "For Whom Corporate Managers Are Trustees: A Note,"

and, finally, Berle's famous book with Gardiner C. Means, *The Modern Corporation and Private Property*, first published in 1932. Our reading resituates these texts in the historical and intellectual context in which they were written, correcting mistaken categorizations that have persisted for decades. The chapter refocuses our earlier work to the history itself and the events of 1932 and the years immediately preceding.

The time was the Great Depression, then believed to have resulted from the inherent instabilities of a capitalist system. The consensus was that emerging, modern corporate institutions were an integral part of the flawed system and thus part of the problem. The question was whether corporations should be treated as public institutions with obligations to mitigate the system's inherent instability, even if these obligations conflicted with maximizing shareholder returns. Parties to today's debate between shareholder primacy and management discretion ignore that question, even as it continues to be posed by the social responsibility rearguard. Today's mainstream assumes maximal returns to the firm as the only end and debates solely about the means, with the dispute centered on the allocation of authority between managers and shareholders.

In contrast, both Berle and Dodd answered yes to the question regarding public obligations. The legal allocation of authority within the firm did come up in their discussion at a secondary level, but in a convoluted posture that can be made intelligible only by reference to the evolution of Berle's thinking in the rapidly-changing political environment of the early 1930s. Any resemblance between the normative issues Berle and Dodd discussed and those in today's debate between management discretion and shareholder rights is more apparent than real.

For Berle and Dodd, the normative issue was the appropriate policy response to the economic crisis. In 1932, when Berle and Dodd started their debate, it was abundantly clear that the job of formulating that policy would fall into the hands of a new Democratic administration likely to be headed by Franklin Delano Roosevelt. It was expected, although not yet certain, that FDR would follow the lead of many European leaders of the time and adopt a form of corporatism as the political economy of the United States.

Corporatism sharply differs from the pluralism that dominated political thinking both before and after the New Deal. Under pluralism, only the preferences of individuals in their role as citizens count in the welfare calculus of government policy, and competition for the votes of individuals in a political marketplace determines policy outcomes. Corporatism privileges cooperation over competition and emphasizes group over individual interests. It assumes that government, through consultation

with the major groups in society, can articulate an objectively cognizable "public interest." Once the public interest is expressed, government calls on the various groups, with the corporation being one of the most important, to adapt their positions in support of it.

Corporatism implies a radical restatement of the purpose of the business corporation. It does assume capitalism and a system of private property rights and has no trouble accepting the legal model under which directors must maximize the value of the corporation. But it does this only at the threshold, the point at which corporations come to the state-directed table where the groups determine the public interest. Given a determination, the calculus of corporate rights and duties must adjust and recognize a public interest constraint. Specifically, corporate directors have a duty to manage the business and affairs of the corporation in accordance with clearly-articulated public policies, even if those policies interfere with the property interests of shareholders. Putting this in the terms of the theory of the firm, corporatism views the corporation as an entity that operates as an organ of the state and assumes social responsibilities.

Both Berle and Dodd brought these corporatist assumptions to their debate. That alone inserts a normative barrier between their discussion and today's back-and-forth between shareholder primacy and management discretion in a pluralist and market-oriented political context. It also introduces a significant contextual barrier between Berle and Dodd and modern CSR. The context in which they wrote is so far removed from that which exists today as to block either side from a legitimate claim to direct ancestry.

That said, interpretive questions remain to be answered. Given the corporatist commonality between Berle and Dodd, how can Berle plausibly have emerged in our historical memory simultaneously playing the roles as shareholder primacy's intellectual grandfather and an early CSR advocate, while Dodd simultaneously is seen by some as CSR's grandfather and by others as a managerialist? And, given the common ground between the two, what exactly put them at loggerheads in 1932? This chapter shows that the conflicting characterizations follow partly from a failure to contextualize and in part from the writings themselves. Each of Berle and Dodd sharply adjusted his own position as events unfolded in their own time. And, while both were corporatists, they differed on the central issue concerning the allocation of power among management, labor, and the state.

Section 2 looks at Berle's evolution from a 1920s corporate lawyer advocating shareholder primacy to maturity as an academic and corporatist public intellectual in the 1930s. The discussion details the basic terms

of corporatist political theory and their brief appearance in federal law in the National Industrial Recovery Act of 1933. Section 3 takes up *The Modern Corporation*, distinguishing the parts of the book that set out Berle's early positions from the parts that reflect the thinking of mature Berle, fleshing out the latter by reference to Berle's contemporaneous political writing. Section 4 unpacks the Berle-Dodd debate, showing how Dodd's corporatist approach differed from Berle's and suggesting that Berle, then playing a prominent role as a corporatist policy advocate inside of FDR's presidential campaign, was disabled from offering a full and direct rebuttal. Section 4 goes on to look at the authors' later rebuttals and recantations. A conclusion follows.

2. BERLE'S TRANSITION FROM CORPORATE LAWYER TO CORPORATIST

Adolf Berle received a Rockefeller Foundation grant for an "inter-disciplinary" study of corporations in 1927, a project that five years' later would result in *The Modern Corporation and Private Property.* The performance of the American economy would change rapidly and radically during the five-year period of research and composition, and so would Berle's ideas about regulation and corporate law. He began the period as an advocate of corporate self-regulation. He soon shifted to a view favoring judicially-enforced shareholder primacy. Reflecting also on the broader political economy, he emerged in 1932 as an advocate of corporatist solutions to the national economic crisis. His views registered strongly both in FDR's 1932 campaign and in the legislative program of the Hundred Days of 1933, when corporatism came to the fore in national regulatory policy. We here recount this development, laying the groundwork for our reconsideration of *The Modern Corporation* and the Berle-Dodd debate.

2.1 From Self-Regulation to Judicially-Enforced Shareholder Primacy

At the time of the Rockefeller Foundation grant, Berle was a Wall Street lawyer with an academic bent. Strictly speaking, that description fit him for the rest of his career: although he took up an academic appointment at Columbia Law School in 1928, Berle never closed his downtown law office. At the same time, Berle the lawyer had published a well-known series of commentaries on corporate law (Berle 1928). Berle focused on management power and the shareholders' inability to control it even in

these early writings (ibid.: v–vi, 26–34, 37). The separation of ownership and control, then a new phenomenon, was occasioning reexamination of settled matters of law. Management power had traditionally been restricted in the articles of incorporation, or, alternatively, by owner-shareholders. By the time ownership dispersed in the early decades of the twentieth century, the large corporations had general charters that omitted the restrictions. Managers emerged with new powers—they could enter new businesses and issue new stock to fund the ventures at will. Courts and legislatures were grappling with how to treat the inherited legal framework in light of this development.[1] Should charters be interpreted as complete contracts and enforced according to their literal terms, or were there implied fiduciary constraints that required judicial intervention?

The Berle of the 1920s favored a contractual approach. He expressed skepticism respecting prospects for constructive judicial intervention (Berle 1928: 36): "[c]ourts cannot be expected to work out rules of conduct for the business community except with the guidance and assistance of business men themselves, and for this purpose business standards must be made apparent."

For this Berle, the problem was that the sources of corporate regulation—corporate charters and statutes—were not helping to make "business standards" apparent. Then, as now, the standard practice favored broad drafting toward the end of according management discretion to run the business. Berle, looking to protect the interests of the holders of shares in publicly-traded firms, saw a need for constraints on management discretion. He wanted the problem to be solved by "business men themselves," and looked to self-regulatory reforms. More particularly, he suggested: (1) that investment bankers organize themselves into an enforcement body to facilitate scrutiny (and screening) of firms making public securities offerings; (2) that the stock exchanges withhold listing from firms whose managers abused their power and demand disclosure of corporate information; and (3) that large institutional shareholders like insurance companies position themselves to obtain accurate information about issuers and to protect shareholder

[1] Statutes of general incorporation became common in the 1870s and 1880s (Hurst 1970: 56). However, this first generation of general incorporation statutes carried numerous restrictions on the form a corporation could take (ibid. 56–7). Over the next several decades, there was debate over how strong these restrictions should be. A second generation of incorporation statutes that made the corporate purpose provisions a default rather than a mandatory provision became common in the 1930s (ibid. 69–71).

rights (ibid.: 37–9). With respect to institutional shareholders he had a more specific suggestion (ibid.: 39):

> Suppose … trust companies were in the habit of accepting, on "custodian account," deposits of stocks from small shareholders, thereby gathering many small holdings into an institution commanding a block so large that protection was worth while, and that they also provided themselves with power to represent the depositors of stock. Such institutions could easily keep themselves informed as to the affairs of the corporation … and, as representing their clients, could take the action necessary to prevent or rectify violations of property rights … .

Ironically, each of the items on Berle's list shows up prominently in governance discourse today (Romano 1998); Mahoney (1997); Black and Kraakman (1996). Those presently advancing these positions do so from the deregulatory wing of the corporate law academy, inviting the label "contractarian." The political implications were quite different in the 1920s. Berle was staking a position as a reformer. Indeed, his approach had a precise analogue in the industrial pluralism of the institutional economist John R. Commons, with its view of the state as the enforcer of bargains entered into by self-constituted groups representing adverse economic interests (Ernst 1993: 66–8). Berle, in fact, contemporaneously published short opinion pieces that speculated about movement toward worker ownership (Schwarz 1986: 65).

Berle's attitude toward regulation would change even before the stock market crashed in 1929 (ibid.: 55). The catalyst was Gardiner Means. Berle's Rockefeller grant required the participation of an economist. This prompted Berle to engage Means, an economics graduate student and childhood friend (ibid.: 51), as a "statistical and economics research assistant" (Berle 1973: 21). Means contributed *The Modern Corporation*'s empirical studies of corporate concentration and dispersed share ownership.[2] His empirical results showed that one-third of the national wealth lay in the hands of 200 large corporations. Means projected that, given continuation of the present rate of growth of that relative share, 70 percent of economic activity would be carried on by 200 corporations by 1950, even as share ownership became more and more dispersed (Berle and Means 1933: 9, 37, 47). The upshot was that economic power was

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[2] Berle eventually conceded co-authorship and one-third of the royalties (Schwarz 1986: 58–9). We will, however, here treat Berle as the author of the text.

concentrating in the hands of a cluster of corporate managers, the same group whose level of responsibility already had come to concern Berle.[3] Means' projections sent a loud and clear message: something had to be done about corporate power, something more than Berle had thought previously. Berle changed his views accordingly. What he formerly saw as a governance problem to be treated contractually within the financial community, he now came to see as a case for judicial control in the name of the shareholder interest (Berle and Means 1933: 56).

Berle (1931) stated this position in "Corporate Powers as Powers in Trust" in the *Harvard Law Review*, an article that previewed legal points in the upcoming *Modern Corporation* without a hint as to the political-economic framework in which the book would encase them. More particularly, the article restates what was then considered the problem of corporate power: "[o]f recent years aggregations of capital have been collected from the public sale of stock in corporations with paper powers which are broad enough to permit them to rove the world at will" (ibid.: 1066). The article then launches into a discussion of fiduciary duty as a means of addressing the problem, asserting that the arguably archaic and longstanding rule that a corporation was for the benefit of its owners remained true when ownership and control were separated. Managers were trustees of the shareholders and so might only exercise their wide ranging powers for the benefit of the shareholders. More particularly: "the use of the power is subject to equitable limitation when the power has been exercised to the detriment of [shareholder] interest, however absolute the grant of power may be in terms, and however correct the technical exercise of it may have been" (ibid.: 1049). The role of the judiciary was to enforce this principle.

This was by no means a settled principle of law. Berle accordingly marshaled the cases, pointing to a variety of rules that constrained exercises of managerial authority. For example, the directors' power to issue stock was limited by the requirement that the ratable interest of existing and prospective shareholders be protected (ibid.: 1050–60). The power of directors to withhold dividends provided a second example: while directors generally had freedom to withhold dividends, courts would force distribution when the reason for the withholding was a non-business purpose (ibid.: 1060–63). Third, the power to acquire stock

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[3] These projections of increasing concentration would prove to be fundamentally wrong, and Berle later adjusted his numbers as the prediction failed to prove out (Berle 1963: 82).

in another corporation had to be used for the benefit of the acquiring corporation and not for managerial interests (ibid.: 1063–6). A final example involved the power to amend the certificate of incorporation. In this setting, the power rested with the majority of shareholders rather than the directors, but the rule remained the same—majority power was subject to equitable limitations (ibid.: 1066–9). The only distinction between the exercise of shareholder power and that of directors was that the "vote of shareholders would at least tend to create a presumption that action taken benefits all of such shareholders." But the presumption could be rebutted by a showing that the majority was a group that had interests adverse to the corporation as a whole.

All of these cases presupposed an active judiciary that would evaluate business decisions on a fact-specific basis. Berle looked to a principles-based rather than rules-based jurisprudence. His remarks on the law of preemptive rights reflected his view of corporate law generally:

> The only conclusion that can be drawn from the tangled history of preemptive rights is that the doctrine arose from an attempt to impose an equitable limitation on an apparently absolute power of directors to issue stock; that it should never have hardened into a rigid rule of law, and that it should revert to its original status as a remedy, available in equity and possibly, by transposition, at law (ibid.: 1059).

Berle summed up with a two-prong test to assess the legitimacy of actions taken by managers: first, whether the technical power for the action existed, and second, whether the action was consistent with the managers' role as a fiduciary to the shareholders. The latter prong was to be guided by the analogous rules of trust law (ibid.). This logic of the proposed test resonates in today's corporation law, as articulated in the Delaware courts, which also looks first for power to act and thereafter asks whether the fiduciary duty to act in the interest of the shareholders has been violated. Special duties also are imposed on controlling shareholders, but the resemblance obtains only at this high level of generality. Berle's article also evinces a deep distrust of managers and a belief that their power needed some form of significant, substantive constraint. Here "Powers in Trust" loses its resonance with today's process-oriented jurisprudence even as it can be tied to the line of contemporary corporate legal theory stressing shareholder primacy. Berle would continue to distrust managers and advocate direct constraint for the rest of his career. But that distrust would very soon reconstitute itself in a form utterly alien to today's advocates of shareholder primacy.

2.2 The New Deal and Corporatism

Thus did Berle make his mark as a corporate law academic in 1931. He also had an interest in national policy issues. *The Modern Corporation and Private Property*, still in preparation, would synthesize both areas of interest. Before turning to that text, we follow Berle the public intellectual to the national political stage.

Governor Franklin Roosevelt reached out to academics for assistance with policy positions early in his 1932 presidential campaign. Roosevelt recruited Raymond Moley, a government professor at Columbia. Moley then recruited Berle for expertise on credit and corporations along with a Columbia economics professor, Rexford Tugwell, for expertise on agriculture. Together they made up the core of what came to be called Roosevelt's "Brains Trust" (Schwarz 1986: 70–3).

2.2.1 The "New Individualism"

Berle sketched out his policy position even before joining the campaign, pitching it to Louis Brandeis in a letter dated 22 February 1932. Brandeis was a prominent "New Freedom" progressive who advocated aggressive antitrust enforcement for the restoration of market competition, prohibition of unfair trade practices, and protection for small business (Brand 1988: 65). Berle, in contrast, thought market competition was part of the problem. Although corporate concentration had gone too far, he wrote, the antitrust platform did not provide a viable approach to the economic crisis of 1932. Better to accept the large economic units and mold them so as to make them useful to the people. State capitalist planning could address the economic crisis even as the individual was protected.

Once inside the campaign, Berle promptly set out these ideas in a memorandum to Roosevelt entitled "The Nature of the Problem" (Schwarz 1986: 74–5). Success with Roosevelt was by no means guaranteed. Although Moley and Tugwell were of one mind with Berle (Brand 1988: 74–5), Roosevelt liked to surround himself with advisors espousing competing positions. One such advisor was Felix Frankfurter, an old nemesis of Berle's,[4] who, along with a cadre of acolytes, still hewed to the economic liberalism of the decades before (Schwarz 1986: 76).

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[4] It might be more accurate to say that Berle was an old nemesis of Frankfurter's. Berle had Frankfurter as a teacher during his first year at Harvard Law School and reportedly harassed Frankfurter rudely and mercilessly during their class sessions. Frankfurter was rumored to have played a role in Berle's not being invited to join the *Harvard Law Review* after his second year. Although

Berle's star ascended, however, and he received the go-ahead from Roosevelt to draft a campaign speech that would represent a philosophical statement of the candidate's economic policy. The speech, entitled "The New Individualism" was delivered by Roosevelt on 23 September 1932 to the Commonwealth Club of San Francisco, a prestigious club of nonpartisan individuals interested in matters of government. The speech—by all accounts the most radical of FDR's campaign (ibid.: 79)[5]—was received tepidly, if not with some hostility (Houck 2004: 261). It has since received a good deal of attention among political scientists, even making a list of the 100 most important political speeches in American history. The speech naturally did not carry Berle's signature, but it is generally agreed that Berle (and his wife Beatrice) wrote it and that Roosevelt accepted it with very minor changes (ibid.: 259–60). It is also agreed that the speech in fact represented its author's views and presaged the economic program of the New Deal. That the speech may not have represented Roosevelt's views is less important for our purposes.

The "new individuals" of the speech were ordinary citizens. They had economic rights – the right to make a comfortable living and the right to own property. Those rights needed to be protected in order to ensure the safety of savings. The parties infringing the rights were corporate managers, the "princes of property" who exercised "powers in trust" (Berle 1973: 69). Note that the text at this point diverges from the shareholder primacy of "Corporate Powers as Powers in Trust." Even as the phrase "princes of property" bespeaks concern about management power, Berle displaced the shareholder as his trust beneficiary with the "new individuals." That accomplished, Berle reached the punch line: private property rights would need to give way in the face of the public interest. Where a year and half earlier the managers' private economic power had implied a private trust, the implied trust was now public.

The speech went on to call for government controls. Continued sufferance of management power depended on the trust's fulfillment: the "princes of property" had to assume responsibility for the public good, end their internecine disputes, come together as industrial groups, and cooperate toward a common end. Should any such group defect from

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Berle's grades were higher than those of some who made the *Review* in that second round, his biographer sees no reason to infer professorial interference, suggesting that Berle had been as unpopular with his classmates as he had been with his professors (Schwarz 1986: 14–15).

[5] The text can be found at the American Rhetoric Online Speech Bank, http://www.americanrhetoric.com/speeches/fdrcommonwealth.htm.

cooperation, the government would intervene with punishment (ibid.: 69). Thus coordinated, firms could serve the people—adjusting production to consumption and distributing wealth more equitably. The chaotic marketplace would be disciplined by "an economic constitutional order." Said Berle, "[t]he day of the manager has come" (ibid.: 67).

Although that last point was debatable, Roosevelt's day would come soon enough and the New Individualism would find its way into public policy. Berle used "new" individualism to contrast with the "old" individualism of Frankfurter and the other New Freedom progressives and its stress on small business and strict antitrust enforcement. "Collectivism" was the more common term at the time (Hawley 1966: 35).[6] We prefer the more precise term "corporatism." Corporatist policies had been debated in European political circles and had impacted European government policy since the late nineteenth century. They came to the fore of policy discussions in the United States in the early 1930s as the depth of the economic crisis became apparent. Berle put it as follows in a memorandum to Roosevelt in the summer of 1932 (Schwarz 1986: 78):

> [I]t is necessary to do for this system what Bismarck did for the German system in 1880, as a result of conditions not unlike these … . Otherwise only one of two results can occur. Either these handful of people who run the economic system now will get together making an economic government which far outweighs in importance the federal government; or in their struggles they will tear the system to pieces. Neither alternative is sound national policy.

Berle's New Individualism speech thereafter brought corporatism to the forefront of American electoral politics.

We acknowledge that the term corporatism is not well known in the U.S. Indeed, those who do know it tend to avoid it,[7] no doubt due to its association with the fascist politics of the European countries that formally adopted corporatism during the 1920s and 1930s (Wiarda 1997: 36–42). But those associations can be put aside here, not only as regards the context of 1932, but as regards the views Berle expressed for the remainder of his career. At the same time, we make only a limited descriptive claim for corporatism. We use it as a heuristic for the texts

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[6] Schwarz (1986: 68) describes Berle's approach in two conjoined phrases: "state capitalism" and "corporate liberalism." "Corporatism" effectively merges the two.

[7] A leading historian of the New Deal (Hawley 1966: 35) describes the early New Deal corporatists as alternatively, advocates of a vision of a "business commonwealth" and advocates of a "cooperative, collectivist democracy."

under discussion and for one subset of New Deal legislation.[8] Thus employed, it highlights the magnitude of the conceptual gulf that separates what Berle, Means, and Dodd talked about from what we talk about today. Corporatism does this particularly well precisely because its operative concepts fell from favor in this country in the wake of pluralism's triumph after World War II. It also facilitates explication of the texts without an unnecessary diversion of attention to the nuances of early twentieth century political-economic thinking. The next subsection sets out our descriptive template.

2.2.2 Corporatist theory

As described by one commentator, corporatism is one of the three great "isms" of the twentieth century, along with communism and liberal pluralism (Wiarda 1997: 5). Although pure forms of any of the three movements do not exist, pure forms serve as useful reference points. In terms of jurisprudence, the three can be differentiated in terms of two core questions: (1) who is enfranchised and thus gets to address the sovereign; and (2) whose preferences count when the sovereign makes its policy decisions?

Liberal pluralism stands at the individualist extreme. Here, only the preferences of individuals in their role as citizens get counted in the welfare calculus of government policy. Policy outcomes are determined by competition for the votes of individuals in a political marketplace. While individuals with shared interests form advocacy groups to compete for favorable policy outcomes, the interest groups themselves have no political status beyond the aggregation of their members' interests. Although corporations, unions, and interest groups count and express their official views, they count only to the extent that they offer informed judgments, political donations, or control votes. Communism stands at the opposite, collectivist extreme. Here, only the party gets to address the state, and only its preferences matter. Firms and unions are instruments to carry out the party's political agenda. Advocacy groups keep a low profile if they exist at all. The people's democracies are democracies only in the sense that the party claims knowledge of what the people should want.

Corporatism stands between the two extremes with a more complex structure. The pivotal distinction between corporatism and pluralism is

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[8] We do not assert that the New Deal was broadly corporatist. New Deal policies and legislation developed in reaction to events and drew on a range of ideologies (Rodgers 1998: 409–12).

that in corporatism, groups are enfranchised as well as individuals. An individual who belongs to a group in a sense gets two votes, with group participation being the more important of the two. Individuals are identified by their group, whether it be their parish, occupational association, industry association, or union organization. The groups then operate as the political actors. Rather than one person-one vote, it is the groups' votes that determine government policy, with the more powerful groups having the most votes (Wiarda 1997: 18). Those outside the shield of a recognized negotiating group have only "the devalued currency of electoral representation" to use one commentator's words (Cawson 1986: 145).

Corporatism emphasizes cooperative relationships among groups and between the state and the different groups. This is based on two principles. The first is the conception of some sort of objectively cognizable "public interest" articulated by the government with consultation from the major groups. Once the public interest is expressed, the various groups are expected to adapt their policies so as to support it (Ziegler 1988: 22). In Berle's New Individualist variant, the public interest is described in terms of the economic rights of individuals.

The number of groups with access to the state is limited in corporatism. Where pluralism envisions an unlimited number of interest groups acting as extensions of many atomistic actors and operating in a competitive political marketplace, corporatist theory sees a limited number of groups, each wielding substantial political power (Cawson 1986: 35). Groups are assembled into hierarchies, and the "peak associations" at the top hold the most influence with government policymakers. The peak associations are groups like industry-wide business associations or national labor federations whose broad membership is thought to discourage narrow conceptions of political interest.

To function properly, corporatism requires group discipline. The peak groups are expected to exert discipline among their constituent local groups so as to maintain cohesive support for national policies. With that accomplished, the peak associations then battle with or serve as counterweights to rival peak associations. For example, union federations are pivotal because they offer a counterweight to the largest corporations, perhaps the most powerful of the peak associations.

While Berle did not stress corporatist modes of political organization, he otherwise fully embraced the corporatist vision, most notably the emphasis on government management of the economy. Corporatism views free competition as a destructive force that has to be both controlled and channeled through institutions that practice fair, but not

free, competition under the watchful, mediating power of the government. In corporatism, fair competition means the "stabilization of business" with prices at levels that simultaneously assure fair wages, yield an adequate return on invested capital, and support high levels of employment. Berle would stress these points during the 1932 campaign, the early New Deal, and for the rest of his career.

2.2.3 Berle's corporatism in practice: the National Industrial Recovery Act

Berle continued to promote the corporatist program in public venues after Roosevelt won the election (Schwarz 1986: 84). He also kept it on the inner circle's agenda during the transition period, generating a legislative research file on antecedent stabilization regimes and, in a memorandum sketching the terms of statutes to be enacted immediately after the inauguration, a brief description of possible legislation (Berle 1973: 78–9). A statute did follow during the Hundred Days—the National Industrial Recovery Act (the "NIRA"). Berle did not, however, participate in its preparation. He had chosen to stay in New York, declining a seat on the Federal Trade Commission (Schwarz 1986: 68). Moley and Tugwell—who had both accepted posts in the administration—served on a drafting team. Roosevelt, pursuant to his usual practice, commissioned a competing draft, in this case from Senator Robert Wagner, whose team included Jerome Frank.[9] The two groups hammered out the final draft in a locked door session on 10 May 1933. The statute, passed by the Congress in June, represented the adoption of corporatism by the U.S.[10] It was the centerpiece of the First New Deal.

The NIRA was administered by the National Recovery Administration (NRA). Like Berle, the NRA's leaders sought to replace a perceived individualistic, selfish, hyper-competitive system with a system built around concerted activity under government supervision. Also like Berle, the first head of the NRA, General Hugh Johnson, believed that capitalism had brought the U.S. to the brink of collapse (Brand 1988: 99–100).

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[9] The drafting teams encompassed an array of competing interests, including business. The bill emerged as a compromise, holding out items for all and leaving much open to later administration (Hawley 1966: 19–26).

[10] It was recognized at the time as drawing from the models being created in Europe (Brand 1988: 83–5). In addition to NIRA, the Robinson-Patman Act (1936), the Davis-Bacon Act (1931), the Miller-Tydings Act (1937), as well as state and local price-maintenance laws, were elements of the move toward a corporatist economy.

At the core of the NIRA were codes of fair competition for individual industries. Trade associations, as the hierarchical peak groups for business, could ask that the federal government approve codes of practices for their industries.[11] The codes, once approved by the NRA, were legally binding on all the firms in the industry. If the trade association proved reluctant to come forth with a code, the NRA could adopt one for it (ibid.: 235).

The codes offered business firms an unusual plum, namely, legalized concert of action as a way out of the disastrous price cutting that had led to alarming numbers of bankruptcies. In short order most of the major industries were covered by codes. The companies that belonged to associations with approved codes were allowed to display the Blue Eagle symbol, which publicly advertised their good standing with the NRA (ibid.: 84).

The NIRA held out an even bigger plum for its other major beneficiary—the unions. At the start of the New Deal, labor was largely unorganized, weak, and entirely unable to serve the functions required for the business/labor cooperation envisioned by the NIRA. NIRA Section 7(a) provided a new platform, augmenting the previously acknowledged right of labor to organize with the right to do so free from interference by employers. In addition, the industry codes, before being approved "had to meet specific conditions regarding the rights of employees to participate in union activities and requirements of employers to comply with maximum work hours and minimum rates of pay" (Roos 1971: 484).

The NIRA got off to a fast start, but it fell apart almost as quickly. The cooperative alliances to which it looked never fully coalesced. Absent cooperation, its economic plan foundered on internal contradictions. The NIRA leadership wanted a system where, "fundamentally decent businessmen would not be forced by competitive pressures to exploit their employees" (Brand 1988: 12). For the system to succeed, unions and businesses had to exercise self-restraint in their bargaining demands and be "responsible," by supporting national priorities over their own priorities. This did not happen (ibid.: 94). Neither management nor labor was willing to play within the new corporatist structure. Strikes and lockouts spread (Dulles 1966: 271–2). Corporations were unconvinced that the relaxation of the antitrust laws was sufficient to compensate for the cost of Section 7(a). Union leaders were in a similar position as members'

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[11] Act of 16 June 1933, ch. 90, § 3, 48 Stat. 195, 196 (terminated 1935) ("Upon the application to the President by one or more industrial associations or groups, the President may approve a code or codes of fair competition for the trade or industry.").

aspirations and militancy increased along with workers' new organizational rights. And unions, more than business, were willing to gamble that the National Labor Board or the President himself would intervene and support their claims in order to restore labor peace.

The new social ethic propagated by the system had not caught on. Nor did the organizational hierarchies envisioned by the corporatist theory appear in practice. Neither the Chamber of Commerce nor the AFL could successfully force member firms or union locals to bring their goals in line with the Roosevelt administration's public policy goals. Nor is it clear that they ever tried to rally their troops (Brand 1988: 140, 284).

Eventually, the NIRA's political base became unstable. It had rested on an alliance of New Deal corporatists and antitrusters (ibid.: 128–9). Both shared a common belief that the free enterprise system had failed, but both, as we have seen, went on to offer diametrically opposed solutions. While the antitrusters supported the wage increases being won by newly organized workers, they were upset with the price increases that were necessary to cover the cost of the increased wage. Reflecting these internal contradictions, antitrusters in Congress began to challenge the codes' price fixing practices as illegal under prevailing law (Lehmbruch and Schmitter 1982: 231).

The NIRA, in sum, was terminal even before it was put to rest by the Supreme Court in *Schechter*.[12] But corporatism did not die with it. Full-blown corporatist policies returned with World War II in response to the need for increases in production of war machinery. Given the exigencies of the war, Roosevelt replaced the soft sanctions of the NIRA with heavy-handed, authoritarian sanctions. The war policies included wage and price controls, and a low tolerance for even lawful work stoppages by unions. When dispute resolution failed, the government had a new policy option to help the parties resolve their disputes: executive orders allowing the government to seize companies. During the war, there were no fewer than 18 executive orders involving labor regulation, and all of the government's industrial seizures in this period were accomplished by executive order. From 1941 to 1945, Presidents Roosevelt and Truman conducted 71 industrial seizures (Sparrow 1996: 73–4).

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[12] *A. L. A. Schechter Poultry Corp. v. United States*, 295 U.S. 495 (1935). In *Schechter*, the Court held that the code-making authority conferred by NIRA was an excessive delegation of legislative power and therefore unconstitutional. The *Schechter* Court's use of the non-delegation doctrine to overturn NIRA is now viewed as a "legal anachronism" because equally broad grants of authority to government agencies have been consistently upheld since the New Deal (Brand 1988: 219).

Berle himself outlined a number of dysfunctional aspects of the NRA's operation in a report he prepared for Hugh Johnson in July 1934. He viewed the NIRA as an experiment and accepted its failure, observing years later that intervention on such a scale occurred in this country only in response to an emergency (Berle 1973: 99–101). But he never abandoned corporatism's underlying economic and political assumptions.

2.3 Summary

In April 1931, Berle made a case for shareholder primacy in a trust context on the pages of the *Harvard Law Review*. In so doing he abandoned his earlier contract-centered views on solutions to corporate problems. The shift stemmed from concern about growing corporate power. But the context remained that of his earlier writing—corporate law, narrowly conceived. By September 1932, Berle had transformed his trust model for the national political economy. As restated in the New Individualism speech, management was to act in the public interest. The shareholder beneficiary was nowhere to be seen. The context was different, of course. Where Berle of the 1920s addressed only corporate law issues during the 1920s, in 1932 he articulated national public policy. We are nonetheless left with two apparently inconsistent Berles. We can bring them closer together, if not merge them into a coherent whole, by reference to *The Modern Corporation*, first published in August 1932.[13]

3 THE MODERN CORPORATION AND PRIVATE PROPERTY

The Modern Corporation captures Berle in the middle of his metamorphosis from friend of shareholders to advocate of the corporation as an instrument for advancing national social welfare. The book thus provides a window into the evolution of his thinking. Unsurprisingly, the transition has some awkward junctures.

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[13] The book was originally published by the Corporation Clearing House, a subsidiary of the Corporation Trust Company. Apparently some of the Corporation Trust Company's affiliates expressed displeasure over the book, and an agreement was quickly struck with MacMillan to become the publisher (Berle 1973: 21–2).

3.1 The Separation of Ownership and Control, the Transformation of Property, and the Trust Model

The Modern Corporation stood for the same proposition as *Powers in Trust*—that something had to be done about management power. But *Powers in Trust* remained in shareholder primacy mode as it argued that the powers of the new management class had to be exercised for the benefit of the shareholders, with no hint of higher corporatist constraints. Berle carried that point over to *The Modern Corporation* and expanded on it.

Most of the book's chapters proceed in the mode of *Powers in Trust*, with Chapter VII of Book II lifted almost in its entirety from the article and reprinted without citation (Berle and Means 1933: 247–76). At the same time, *The Modern Corporation* sandwiched its expanded discussion of the shareholder trust model between introductory and concluding chapters that offered a more general discussion of the sources and implications of corporate power. This exposition, although still largely articulated within a narrow corporate law framework, laid theoretical groundwork for both Roosevelt's New Individualism and the NIRA.

The book made a series of positive assertions about the wider political economy, all grounded in Means' numbers. Economic power was becoming concentrated in the hands of a cluster of corporate managers. The corporate system had developed certain significant attributes and powers, and it now amounted to a major social institution. Individual property had gone into a "collective hopper" which had brought forth huge industrial oligarchies (ibid.: v, 1). The oligarchs exercised unified control over the wealth under their charge. If Means' predictions were accurate, the industrializing American economy could not possibly operate competitively. Each market would be dominated by only a few firms.

The Modern Corporation took pains to underscore the role corporate law played in investing this economic and social power. The law had taken on this role inadvertently, based on a set of assumptions shared with classical economics. Under the shared, nineteenth century vision, production and trade were usually conducted by self-employed individuals. Corporate production was an exception limited to special situations. Limitations on corporate authority were thought inevitably to accompany that special status and corporate law was thought the appropriate means of limitation. But corporate law had stopped placing limits on corporate operations during the course of the nineteenth century. It had done so to facilitate the appearance and success of the large, mass-producing, management-controlled corporation. As the book noted,

the change had been reactive rather than purposive—an acknowledgement of underlying economic facts (ibid.: 2, 141). Despite this, the transition from the classical economy implicated the law in the creation and perpetuation of an unsatisfactory situation.

In the classical model, profit-maximizing individual entrepreneurs both own the means of production and make all decisions respecting production and consumption. Power relations are bilateral: one actor can affect another's behavior only indirectly, by refusing to contract. The result is market competition that effectively controls the producers, constraining both the incompetent and the greedy, and legitimating private economic power. But, argued Berle in *The Modern Corporation*, corporate mass production on a large capital base does not fit within the classical model's legitimating parameters. As the book pointed out, the big corporations of the twentieth century had split the classical entrepreneurial function between salaried executives who sat atop hierarchical organizations, and anonymous equity participants who held small stakes and prize market liquidity over participation. With control and ownership separated, managers were newly empowered. The interests of the owners and managers often diverged, while many "checks which formerly operated to limit the use of power" had disappeared. Problems of not only competence but of responsibility followed, problems largely absent in an ideal capitalist world inhabited by self-employed individual producers (ibid.: 1–9).

Consequently, what Berle had once seen as a problem for private actors in the world of finance now came to seen as a problem for government. The collective aspect of corporate production implied that standard individualist defenses against government intervention no longer applied (ibid.: v). Moreover, the separation of ownership and control had a further positive implication—corporate property should no longer be deemed private property: "It is entirely possible and some students of the situation are beginning to contend, that the corporate profit stream in reality no longer is private property, and that claims on it must be adjusted by some test, other than that of property right" (ibid.: 247). With this transformation of corporate profits from purely private property to property touched with a public interest, *The Modern Corporation* intersects core corporatist theory. Berle could have had the New Individualism and the NIRA in mind with a follow-up point (save for the emphasis on judicial enforcement): "[P]rivate property may one day cease to be the basic concept in terms of which the courts handle problems of large scale enterprise and that the corporate mechanism may prove the very means through which such modification is brought about" (ibid.).

These prescriptive projections earned *The Modern Corporation* high regard in New Deal circles. *Time* magazine would label it "the economic Bible of the Roosevelt administration" one year after its publication (Hovenkamp 1988: 1685). With the economy in severe crisis, it was reasonable to conclude that free competition carried with it a destructive curse. Something needed to be done to make free competition less threatening and *The Modern Corporation* cleared the path of free-market objections.

The book otherwise had little to offer New Deal legal reformers. It nowhere recommended a pervasive system of government oversight, corporatist or otherwise. The reference to the "princes of property" in the New Individualism speech drew on rhetoric familiar to readers of *The Modern Corporation*, which referred to "princes of industry." But the book coined the phrase without setting out any implications: they were "princes of industry, whose position in the community has yet to be defined" (ibid.: 6). Berle reserved his definitional follow-through for the political sphere.

The book did not even suggest much in the way of corporate law reform. While it treated securities underwriting and trading in detail, describing the prevailing legal framework and predicting new regulation in the future, it made no specific suggestions (ibid.: 289–331). Such new law as the book advocated followed from the trust model and shareholder primacy: state-level common law directed to the problem of management self-dealing. But equivocation showed up even here. On the one hand, the enforcement of the equitable limitation to exercise power for the shareholders' benefit could be remitted to the judiciary safely in theory, the common law of fiduciary duties being the only area of corporate law that had not undergone a steady weakening process due to charter competition. "Flexible and realistic" judges, "if untrammeled by statute," could be expected to find solutions to problems that demanded a remedy (ibid.: 221–2, 335–6). On the other hand, it was by no means certain that courts would step up to the task. Only an "expert and courageous court [would] apply this theory to most of the corporate problems reaching litigation" (ibid.: 276). Thus the position of shareholders in large corporations remained perilous. "In fact, if not in law, at the moment we are thrown back on the obvious conclusion that a stockholder's right lies in the expectation of fair dealing rather than in the ability to enforce a series of supposed legal claims" (ibid.).

Had the book closed with this appeal for a shareholder trust model, it could stand today as an historical monument to shareholder primacy, however far ranging its discussion of the social and economic problems posed by management power. But Berle himself prevented that result by

stating the opposite position in *The Modern Corporation's* final chapter, six pages entitled "The New Concept of the Corporation."

3.2 The Last Chapter

The last chapter begins with a general excursus on private economic power. Those who have it desire it. But they inevitably come into conflict with those they affect, who wish to redirect the power's exercise so as to share in attendant benefits (ibid.: 353). Thus does private economic power trigger demands for a social response. Although the conflicts are inevitable, Berle writes that particular outcomes depend on particular political economic contexts (ibid.: 354): "How will this demand be made effective? To answer this question would be to foresee the history of the next century. We can here only consider and appraise certain of the more important lines of possible development."

The chapter then turns to themes developed earlier in the book. While the separation of ownership and control disempowers the shareholders, shareholder empowerment does not figure among the political responses the book envisions. Berle dismisses the shareholders as "inactive and irresponsible," and goes on to pose three alternative responses to corporate power. First, society could leave managers unconstrained, but only if we were ready to face the "danger of a corporate oligarchy with the probability of an era of corporate plundering." Second, society could cut off management self-dealing by strictly insisting on adherence to the shareholder trust. Third, society could step away from the tradition of private property rights and insist on corporations following government mandates (ibid.: 355).

The chapter opts for the third alternative, positing a "wholly new concept of corporate activity" but following up with little in the way of specifics. Indeed, Berle did not see specification as his job. It was up to the community to put forward its demands "with clarity and force" in the new corporatist state he projected (ibid.: 356). *The Modern Corporation* had the limited but still necessary job of clearing away the conceptual underbrush of property rights. With the field open, the public could act and impose a new regime of government/corporate partnership.

Such specification as we get does follow the corporatist template, looking toward the cooperative determination and realization of an objectively cognizable public interest. "[O]nce a convincing system of community obligations is worked out and is generally accepted," private property rights will necessarily have to yield. Corporate leaders will use their power for social betterment (ibid.: 356):

> Should the corporate leaders … set forth a program comprising fair wages, security to employees, reasonable service to their public, and stabilization of business, all of which will divert a portion of the profits from the owners of passive property, and should the community generally accept such a scheme as a logical and human solution of industrial difficulties, the interests of passive property owners would have to give way.

Managers are envisioned as "purely neutral" technocrats making allocative decisions across groups in society "on the basis of public policy rather than private cupidity" (ibid.)

The chapter is as notable for caution as it is for grand political economic vision. It poses corporate social responsibility as an inevitable demand, but it does not purport to lock us into a given means of meeting the demand. It tells us only two things. First, demands for corporate social responsibility will emerge so as to suit particular political and social contexts. Second, the social demands will have to be clearly and forcefully stated, and only then can private property rights be expected to yield.

The last chapter thus poses the corporatism only as a possible alternative. It goes no farther as regards the program's particulars, but that only makes sense. Berle, desiring political influence himself, was keenly aware that it was FDR who would make the final decision and was not about to foreclose any options before the fact in a book chapter. That said, the chapter does go for broke with its vision of a brave new world of empowered management technocrats. The vision needs to be contextualized carefully. Berle's managers become empowered only if they successfully redirect their resources to maximize social welfare. And their power is only that of technocrats—experts who effectuate instructions delivered by a government policymaker vested with the legitimacy of public office. There is nothing here for a modern proponent of corporate social responsibility in a deregulatory state.

Berle later would suggest that the last chapter was what the book was all about—a few pages for the general reader "too lazy, busy or uninterested to read three hundred pages of academic argument" (Schwarz 1986: 63). His concerns about the general reader are understandable, but we wonder whether his comment also bespeaks recognition of a compositional problem. Berle had started the book back in the 1920s as a corporate lawyer's project, a study centered on the role of corporate law fiduciary duties in controlling managerial excess. But his coauthor's contribution had broader-ranging, even contradictory, implications. If Means was correct, the problem of corporate power could not be cabined in a shareholder trust model, and judicial intervention

certainly would not suffice as a remedy for the separation of ownership and control. We believe that Berle suspected as much himself as he wrote the book, but had not yet worked out a satisfactory, integrated approach. The last chapter's jump amounted to a temporary patch.

Berle's published, public posture did not incorporate his shift to corporatism as the book neared publication in August 1932. As we have seen, he had only recently staked out a public claim for shareholder primacy in "Powers in Trust," a position that stood in tension with the book's more broad-ranging emphasis on the dangers of corporate power, and directly contradicted the assertions in the last chapter.

It must thus have come as a rude and unwelcome shock to Berle when E. Merrick Dodd, a Harvard Law professor, used the pages of the May 1932 *Harvard Law Review* to respond to *Powers in Trust* a year after its publication. Dodd attacked Berle's shareholder primacy position (Dodd: 1932:8), forcing Berle to defend a position that he himself already had substantially modified even as he was about to publish a book that, somewhat awkwardly, took both positions simultaneously. Even worse, Dodd attacked from a corporatist position.

4. THE BERLE-DODD DEBATE

To understand the Berle-Dodd debate is to see Berle and Dodd participating in a national political discussion over the outlines of the new American corporatism. How much should the United States's version of corporatism differ from that taken in many of the European countries that were becoming (or had become) corporatist? This was the key political issue at the time, and it was on this point that Berle and Dodd differed. The question went to the allocation of power as between corporate managers and the state. One faction, which Ellis Hawley describes as the advocates of a "business commonwealth," wanted to delegate planning authority to industrialists themselves (acting through trade associations), relegating government to a backstop, supporting role (Hawley 1966: 36–43).[14] The other faction, called the "collectivist democrats" or

[14] This group's operative ideas descended from the "associationist" movement of the 1920s—a small business initiative geared toward protectionist trade associations and against antitrust. Big business co-opted the ideas after 1929 and took the political lead. Brinkley (1995: 34–5) describes associationism as follows:

> Those who promoted the associational approach to economic reform … were much less concerned … about protecting capitalists from government. To

"planners" by Hawley, was suspicious of business, questioned the empowerment of industrialists, and wanted government to hold ultimate control. There also was a subsidiary question. As we have seen, corporatism seeks coherence by limiting the number of groups with access to the state. The groups granted access come to the corporatist table wielding substantial political power. But which groups? In the business commonwealth vision, the new regime would admit only the corporate establishment to the table, respecting the prevailing power structure. The planners, who followed a progressive political agenda, included labor in the selection (ibid.:43–6).

Berle was a planner and a progressive, and so distrusted the managerial elite, or, in his terms, the "princes of property." At the same time, as a progressive, he viewed labor unions as a critical countervailing power against corporate management. In economic terminology, the progressives' view of corporatism followed from a particular view of society's welfare function. That welfare function saw unions as a public good and favored empowering the less well-off as against the princes of property. It was this progressive model of corporatism that Berle brought to Roosevelt.

Dodd came to corporatism as a supporter of the business commonwealth, which put him to Berle's right in the context of the politics of the day.[15] He develops his position by quoting liberally and favorably from two public figures with known political positions on the business commonwealth side—Owen D. Young, chairman of the General Electric Corporation (GE) and Gerald Swope, GE's president. Young and Swope were leaders of the "New Capitalism" (Filene 1930), the name given to their policy of adopting what today would be considered modern employment policies. In addition, Swope had formulated and promoted a plan for confronting the economic crisis. Under his model, managers would be accorded a crucial role in planning and allocational decision-making not only within the firm, but within the national government. However activist Swope may have been in advocating changes in business policy, his bottom line was to maximize the profits of the emerging modern GE.

> them the greater challenge was protecting the business world from excessive competition … . Like Europeans developing a rationale for corporatist experiments in managing industrial economies, some Americans yearned for political arrangements that could produce social and economic harmony.

[15] Dodd's private writings place him more in alignment with Berle (Elson and Goossen 2016).

The Berle-Dodd debate emerges as a clash between the different visions of corporatism whose advocates were then vying to capture Roosevelt's attention.

4.1 Dodd's Attack

Dodd's "For Whom Are Corporate Managers Trustees?" started by paying brief homage to Berle's desire to constrain managers from transferring the assets of the corporation to their own pocket (Dodd 1932: 1147). But Dodd quickly switched to the attack, stating that Berle's shareholder trust view was problematic because "it [wa]s undesirable … to give increased emphasis at the present time to the view that business corporations exist for the sole purpose of making profits for their stockholders." Instead, corporations should act as social institutions (ibid.: 1148).

Dodd believed, correctly, that corporatism was making its way across the Atlantic and highlighted various constitutional and statutory foundations of corporatism already in place, foundations with transformative implications for corporate law. He pointed to *Munn v. Illinois*,[16] an 1877 Supreme Court case which held that the state of Illinois had the power to set maximum prices for grain storage because such enterprises were "affected with a public interest." He believed that the rule of *Munn* could be broadly extended: "it may well be that the law is approaching a point of view which will regard all business as affected with a public interest" (ibid.: 1149). Moreover, in the industries that were already clearly affected with a public interest—the public utilities—corporatist-like statutes had already been enacted. The Adamson Act, which covered the railroad industry, was "a thinly disguised measure for increasing wages," and thus clearly an example of workers' economic security taking precedence over shareholders' profit (ibid.). Dodd noted that "the more advanced states" had extended such legislation to other utilities, such as gas, electric, and telephone (ibid.:1151).

Dodd believed that piecemeal adoption of corporatist policies would no longer suffice—a more widespread reform was in the offing. "There is a widespread and growing feeling that industry owes to its employees not merely the negative duties of refraining from overworking or injuring them, but the affirmative duty of providing them so far as possible with economic security" (ibid.:1152).

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[16] *Munn v. Illinois*, 94 U.S. 113 (1877).

Support for a social model of the corporation, noted Dodd, "is no longer confined to the radical opponents of the capitalistic system; it has come to be shared by many conservatives who believe that capitalism is worth saving, but that it can not permanently survive under modern conditions unless it treats the economic security of the worker as one of its obligations … ." (ibid.). Dodd found support for this view in his colleague from across the Charles River, Wallace Donham, Dean of the Harvard Business School, whom Dodd quotes as saying, "[t]he only way to defend capitalism is through leadership which accepts social responsibility and meets the sound needs of the great majority of our people" (ibid.: 1155).

Dodd believed that the corporatist policy for the U.S. should be based on the presumption that the managerial elite, given the appropriate mandate, would act as trustees for the community and use their corporations to resolve the economic and social problems of the Depression. Extensive regulation would be unnecessary, and "[t]he principal object of legal compulsion might then be to keep those who failed to catch the new spirit up to the standards which their more enlightened competitors would adopt voluntarily" (ibid.: 1153).

Dodd professed the utmost faith in managers and their sense of professional responsibility. He proclaimed that "[p]ower over the lives of others tends to create on the part of those most worthy to exercise it a sense of responsibility" (ibid.: 1157). He noted that as "some of our business leaders and students of business tell us, there is in fact a growing feeling not only that business has responsibilities to the community but that our corporate managers who control businesses should voluntarily and without waiting for legal compulsion manage it in such a way as to fulfill those responsibilities" (ibid.: 1153–4). Such business leaders included the above-mentioned Young and Swope.

Dodd quoted Young and his constituency view of the corporation at length. Young "saw rising a notion that managers were no longer attorneys for stockholders; they were becoming trustees of an institution" (ibid.: 1154). Young acknowledged that the Great Depression was an important element in this new view of the corporation as an institution that had to serve not only the interests of its stockholders, but also the interest of its employees, and customers (ibid.).

Swope, as noted earlier, had actually disseminated a plan for economic recovery, known as the Swope Plan. The plan, which had received widespread media attention, had been unveiled in late September 1931 at the annual dinner of the National Electric Manufacturers' Association in New York (*Time* 1931). It had manifest political implications. The leading proponents of the plan, including Swope himself, had extensive

political connections. Young, a strong plan supporter, was a speculative Democratic Presidential candidate. So was Silas Strawn, president of the U.S. Chamber of Commerce. Strawn's successor, Henry Harriman also supported the plan. In fact, according to Hoover's memoirs, Harriman advised Hoover that if he did not support the plan, big business would put its money and influence behind Roosevelt, who had purportedly signed on. For his part, Swope shopped the plan in Congress, testifying before multiple committees, including Senator La Follette's hearing regarding the establishment of a National Economic Council (Himmelberg 1993: 127, 131, 203, 206).

The business component of the plan was essentially the same as that of the later NIRA— mandated cartelization through trade associations supervised by the federal government for the purpose of stabilizing prices and production. The labor component, however, differed materially. The Swope Plan called for companies themselves to establish and administer plans for worker's compensation, life and disability insurance, pensions, and unemployment. This paternalistic approach to worker welfare left all aspects of the recovery program firmly in the hands of business and indeed was adopted from policies already pursued by Young and Swope at GE.

Although Swope does not appear to have taken an active part in drafting the NIRA, it safely can be assumed that his plan, as a focal point proposal from the business side, was among those reviewed by the two drafting committees during the Hundred Days.[17] As we have seen, the statute that emerged gave considerable power to labor unions in setting the recovery agenda by effectively forcing business to sit at the same negotiating table. Big business was not pleased: the president of a leading trade association accused Senator Wagner of betraying his business supporters by accepting the amendment that added Section 7a (Hawley 1966: 207).

Dodd's approving discussion of Young and Swope has two implications. First, it places Dodd firmly in the corporatist camp. As was recognized at the time, Swope and Young were advocating a model of corporate activity that was very different from the traditional one. The model centered on a corporatist tradeoff: corporations would give up some portion of their market freedom in exchange for stability and relief from the destructive swings of the business cycle. Second, it aligns Dodd with the business commonwealth corporatists. Rather than view the

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[17] Moley reviewed proposals emanating from the Chamber of Commerce, the Wagner draft centered on industrial self-governance (Hawley 1966: 23–5).

"princes of property" with suspicion, as Berle did, Dodd saw them as the solution to the nation's economic ills.

Significantly, this business commonwealth posture did not necessarily put Dodd at variance with the goal of corporate profitability. The labor-management regime Swope had instituted at GE in the 1920s had indeed featured premium wages and benefits at levels higher than necessary to clear GE's labor market. There had been no give-away, however. Swope and Young broke with the old capitalism in supporting modern employment policies. In their view, GE would have higher profits if it paid wages high enough to reduce turnover to the point where it reduced unit labor costs. In a 1927 speech to the Harvard School of Business Administration, Young stated that "[s]lowly we are learning that low wages for labor do not necessarily mean high profits for capital." Swope and Young were in the same mode when they accepted labor unions—they thought unions were essential to maintaining a steady, productive workforce, and because they feared that an alternative might be a radicalized workforce (Schatz 1983: 14–16).[18]

GE, then, had been pursuing efficiency effects that more than covered the incremental labor costs. The Swope Plan reflected GE's interests at the time of its promulgation, with its national product cartel, federal subsidies for employee benefits, and tax abatement for firms vulnerable to competition from foreign firms with lower-paid employees (Swenson 2002: 204). Even as Young and Swope talked constituent interests, there is no reason to believe that they viewed themselves as defectors against the shareholders. And the strategy had worked during the expansionary 1920s. But it did leave GE at a disadvantage against lower-paying competitors during the Depression (ibid.: 182–3).

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[18] Swope and Young sought friendly relations with union leaders, taking what could be characterized as an "if you can't beat them, join them" approach. It was clear that socialism was gaining popularity among the workers, and the push for union representation was strong (McQuaid 1977: 325). The GE approach was to push for one industrial union rather than a splintering of craft unions. When confronted with ambitious and successful union leaders, GE would offer them management positions. In the early days of the union movement, such beliefs were reasonable (Wachter 2007). The leadership that replaced Swope and Young viewed them as naïve in their attitudes toward unions once it was clear that the union wage was above that paid by competing nonunion firms (Schatz 1983:170–71).

4.2 Berle's Rebuttal

We do not know whether Dodd, as he wrote "For Whom Are Corporate Managers Trustees?", knew that Berle already had moved away from shareholder primacy to a contrasting corporatist position. If Dodd did know, his article makes for doubly interesting reading as an exemplar of strategic academic writing.

The attack gave Berle a jolt—a progressive planner who had taken pro-labor positions in his popular writing, he had not expected an attack on his corporate law position from the other corporatist camp (Schwartz 1986: 65). The problem was that Berle no longer wanted to defend shareholder primacy, at least not in a framework discussing the corporation's role in the wider political economy. Nor was he keen to engage in a public debate about corporatism. We suspect he thought the timing was wrong. The battle between his progressive vision of corporatism and business commonwealth corporatism was taking place behind closed doors. Berle wanted to ensure his vision of corporatism was the one that would be adopted by an incoming Roosevelt Administration and presumably was jealous to protect his influence. We doubt that Berle's fellow Brains Trusters would have welcomed participation by one of their number in an open academic debate between the progressive and the conservative supporters of corporatism. Roosevelt had not yet nodded in their direction; the New Individualism speech still lay in the future. In any event, Berle was unlikely to have seen the *Harvard Law Review* as an appropriate venue for an exposition of his full view. Although this was well-enough formed for an FDR campaign speech, he may not have been ready for a structural exposition and defense in a legal academic context.

Berle's answer to Dodd, "For Whom Corporate Managers Are Trustees: A Note," appeared in the next issue of the *Harvard Law Review*. It was a brief but forceful counter-punch that avoided responding to Dodd's corporatism broadly, and focused only on mechanics. Berle attacked the idea that managers could be trusted to use discretionary power for the welfare of others as the naïve and out-of-touch thinking of an ivory tower academic. Berle caustically remarked that Dodd's argument "is theory, not practice" and "[corporate lawyers] know what the social theorist does not" (Berle 1932).[19] The key insight that Berle attributed to these

[19] One wonders whether this was an oblique reference to the fact that Dodd had practiced law for only three years before becoming an academic (Chafee 1952: 380). Berle also might have been deflecting attention from the fact that the corporatists with real-world experience were on the business commonwealth side, the planners tended to be intellectuals (Hawley 1966: 44).

corporate lawyers is that a management-coordinated, multiple constituency system simply would not work.

The problem was that unconstrained managers would maximize their own welfare. Specifically: "it must be conceded, at present, that relatively unbridled scope of corporate management has, to date, brought forward in the main seizure of power without recognition of responsibility—ambition without courage" (ibid.: 1370). The danger was that "[w]hen the fiduciary obligation of the corporate management and 'control' to stockholders is weakened or eliminated, the management and 'control' become for all practical purposes absolute" (ibid.: 1367). To make managers trustees for the community would free them of any meaningful constraint because almost all corporate activity could be justified in the interests of one group or another.

In other words, Berle responded to Dodd from a progressive position strongly opposed to giving managers added discretion in the emerging corporatist society. The essay does not advocate shareholder primacy. Perhaps it gets that label because it is read together with Dodd's attack. Dodd addressed only "Corporate Powers as Powers in Trust," a paper that by its terms addressed only corporate law writ small—managers and shareholders as against each other with no reference to the wider political economy. Dodd's attack lifted Berle's case for shareholder primacy out of the small corporate law box and attacked it as Berle's statement of priorities in the wider political economic context.

Berle's response, even as it defends the corporate law duty to shareholders, does not assert that the shareholder interest can be viewed as a political and economic proxy for the interest of the wider polity. It does, however, dance around that point. Berle saw stock ownership as a means to "provide safety, security, or means of support for that part of the community which is unable to earn its living in the normal channels of work or trade" (ibid.: 1365) and estimated that half of America's savings were in the stock market (ibid.: 1370). However, shareholders got their legitimacy as passive recipients of wealth created. Shareholders thus were the legitimate and only claimants to corporate profits, not necessarily because they are the owners in the traditional property sense, but because they represented to some extent the welfare of the general public. The shareholder interest, thus legitimated, easily could be confined to a secondary role if the public interest required redirection of the corporate entity's goals.

Meanwhile, discretionary managers jeopardized this legitimate flow of profits to shareholders by both allowing managerial expropriation and inviting "economic civil war." Without clear criteria, even well-intentioned managers would have little basis for choosing among the

competing interests of various constituencies. Recognizing this, many groups would use force and threats—laborers would strike, shareholders would sue, and consumers would boycott—to gain a greater share of the corporate wealth (ibid.: 1368–9).

In any event, argued Berle, practicing lawyers were better suited than managers to develop the law needed in the new corporatist state. Despite rare examples of managerial visionaries like Mr. Swope and Mr. Young, one could not expect broad, enforceable corporate reform to come from managers (ibid.:1372). That job fell to lawyers, who were familiar with the legal system and wrestled with it every day. Berle took care to include himself in this vanguard, remarking that "as lawyers, we had best be protecting the interests we know, being no less swift to provide for the new interests as they successively appear" (ibid.: 1368). Thus having designated himself the drafter, Berle set the stage for his own corporatist proposal (ibid.):

> Either you have a system based on individual ownership of property, or you do not. If not—and there are at the moment plenty of reasons why capitalism does not seem ideal—it becomes necessary to present a system (none has been presented) of law or government, or both, by which responsibility for control of national wealth and income is so apportioned and enforced that the community as a whole, or at least a great bulk of it, is properly taken care of.

But he went no farther. Like *The Modern Corporation*, Berle's response to Dodd signals that something new is coming without telling the reader what he expects it to be. Like *The Modern Corporation*, it only lays groundwork. Meanwhile, the response carefully limits its attack to the managerial vision of corporatism, lest it undermine Berle's own yet-to-be-stated version.[20] Berle would succeed in getting FDR to make the statement soon enough in the New Individualism speech. For whatever reason, he thought the timing, June 1932, and the venue, the *Harvard Law Review*, inappropriate for a statement of his full view.

Given all of this, does the response to Dodd stand for shareholder primacy? It does so only inside the narrow context of corporate law, and then only subject to the proviso that the national government still could take responsibility for stating the social welfare function and imposing it on the managers.

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[20] A later commentator suggested that Berle added the social responsibility paragraph to the final chapter of *The Modern Corporation* at the last minute to cover the flank exposed by Dodd (Schwarz 1986:66).

4.3 Further Proceedings

Berle, vying for influence directly as a member of the Brains Trust, ended 1932 as the debate's political winner. But the issues persisted in the wake of the failure of the NIRA. The corporatist planners' ascendancy in the Roosevelt administration was short-lived. After the failure of the NIRA, the New Freedom trust busters would gain the upper hand (Hawley 1966: 149–86, 325–43). Meanwhile, Berle and Dodd continued their engagement. Dodd (1935) came back to restate his case for management discretion in a corporatist state in a riposte aimed at Berle's instrumental case for the shareholder interest. Then, in 1941, he came back yet again with an essay that abandoned his previous positions. In this final appearance he stepped away from corporatism and returned to normalcy, withdrawing his support from management and reinstating the shareholder as corporate law's beneficiary, in effect ending up where Berle had started in 1931 (Dodd 1941). Not to be outdone, Berle himself revisited the debate in 1954, conceding that Dodd had been proven right over time (Berle 1954: 169).

Berle (1962: 442–3) would elaborate further in a back-and-forth with Henry Manne in the *Columbia Law Review*, taking a short qualifying step backwards:

> [In t]he discussion I had with the late Professor E. Merrick Dodd … I … took the same side that Professor Manne does now, though for rather different reasons. I was afraid of corporate managements as social statesmen, or possibly as controlling fund-donors of universities and other philanthropies, not because I objected to the job being done, but because I thought corporate managements were not especially qualified to do it. In doing it they might revert to their classic profit-making function, and in that case would do it badly—or worse. Events in the corporate world pragmatically settled the argument in favor of Professor Dodd … .

Dodd, then, had been right only as a practical matter—a practical matter contingent on the course of future events. By hypothesis, Berle maintained the view that Dodd had not been correct at the time of publication in 1932. Berle's later reversal thus does not signify unqualified acceptance of Dodd's status quo vision of managers as benevolent hierarchical superiors.

What had changed? Berle believed that everything had changed upon Roosevelt's 1933 inauguration, a view he articulated in a series of post-war books and articles. These works elaborate on the themes of the New Individualism speech, setting out a political economy unique to

their author. In this modified corporatist construct, two prevailing conditions render corporate power benign—first, government management of the economy from an unchallenged position of higher authority and, second, a solid political consensus in support (Bratton and Wachter 2008). Caught between the two, managers seeking to forestall new regulation meeting new public demands had become social co-operators. Absent the essential background conditions, however, there is no basis upon which to infer from Berle an endorsement of management in a primary role as an economic and social allocator.

5. CONCLUSION

The Berle-Dodd debate of 1932 is easily (and frequently) misread. When modern observers read the texts out of context, Berle appears to be the supporter of modern shareholder primacy, which is a position he did hold, but only prior to his political metamorphosis and only in the strict confines of corporate law. Dodd, on the other hand, is interpreted in modern terms as a supporter of corporate social responsibility. In fact, neither was supporting either position. Both were speaking to the politics of their day, defending different visions of the emerging corporatist state, Berle's on the left and Dodd's on the right.

Berle thus ended up as the putative grandfather of shareholder primacy by happenstance, and, ironically, only because Dodd's attack placed him in that position. By the time of the debate with Dodd, Berle was no longer a shareholder advocate. Addressing political economy rather than corporate law, he saw no role for shareholder primacy.

At the time Dodd mounted his attack, the printed record did not yet reflect Berle's shift. *The Modern Corporation* was only just coming to publication. Dodd attacked the only Berle in view, attributing to him a political economy based on shareholder primacy. As a business commonwealth supporter, Dodd attacked using corporatist reasoning. Hence, it is Dodd's article that staked out Berle as a shareholder primacy advocate in the political context of the national crisis. Berle responded not by defending shareholder primacy in the wider context, a position he had already abandoned, but by using the shareholder interest to attack Dodd's advocacy of management discretion to choose appropriate social goals in the new corporatist state. Berle's response thus amounts to a classic anti-managerial argument. But the shareholders figure into it as mere stalking horses in a campaign directed against the business commonwealth vision. Berle's objective was to clear the field for the progressive

version of corporatism. Even as his anti-managerial argument is interpreted today to favor shareholder primacy, the opposite was the case.

Unfortunately for modern readers, Berle did not make this explicit. Our conjecture is that his sensitive role as an advisor to Roosevelt had a disabling effect. The Berle-Dodd debate appeared in May and June of 1932 when Roosevelt, almost certainly the Democratic Party's presidential nominee, was only beginning the process of articulating the main points of his New Deal. FDR only would publicly embrace progressive corporatism in September when he delivered Berle's New Individualism speech. The speech amounts to the central statement of Berle's position, albeit without the usual incident of public attribution. It confirms that the final chapter of *The Modern Corporation* amounts to the definitive statement of its author's views.

Subsequent events make the 1932 debate even more problematic to today's readers, and hence more difficult to decipher. Like ships crossing in the night, each author went on to make public concessions to the other. Dodd, having abandoned corporatism and returned corporate law to its narrow box of fiduciary duty and securities laws, could concede that Berle had been right all along as a shareholder advocate. On the other hand, post-war Berle remained the progressive corporatist of 1932. The NIRA and the formal corporatism of the Roosevelt administrations were long gone. But, in Berle's view, the post-war regulatory state nonetheless accomplished their key objectives, allowing him to "concede" that Dodd's view of management had been proven correct over time.

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21. Corporate law and the history of corporate social responsibility

Lyman Johnson

1. INTRODUCTION

The stunning rise of private business corporations over the last two centuries brought profound social, cultural, environmental, and political change to free societies, as well as greater financial and economic prosperity.[1] The vast influence of the corporation also spawned basic, enduring questions about corporate responsibilities. These include: for what is a business corporation responsible—private gain only or some broader social good, or both?[2] To whom are corporations and their key decisionmakers responsible? Who should have voice on and decide issues of corporate responsibility—only certain corporate actors, or also government officials—and by what metrics will success or failure be determined? What are the respective roles of mandatory legal rules versus optional volunteerism? Finally, how, within the field of corporate law specifically, have these issues been addressed over history, and what factors have shaped how, or whether, corporate law grapples with these questions having larger social salience?

The legal vein runs conspicuously through historical concerns about corporate behavior, especially with the emergence of the multi-unit global corporation the annual income of which may exceed that of many nations. Such powerful institutions understandably prompt evolving, and contentious, social expectations about "responsible" corporate conduct

1 In recent years, concern has grown that the material prosperity generated by corporate businesses is not equitably distributed among all groups in society but has disproportionately gone to upper income or wealth groups (Saez 2015, Piketty 2013). Still, financial inequality is less today than in 1800 or 1900, as are overall levels of poverty.

2 A 2008 study examined 37 definitions of "corporate social responsibility" and distilled five recurrent dimensions: environmental, social, economic, stakeholder, voluntariness (Dahlsrud 2008). Nonetheless, the question of whether a particular practice, company, or law does or does not promote "social responsibility" can sometimes be a controversial matter.

under constantly changing conditions. The legal thread, moreover, has two intertwined strands, that of positive law, and that of the larger culture of discourse about corporate power and the appropriate social control of that power and those who wield it. Many shared beliefs about the proper corporate treatment of consumers, employees, investors, creditors, philanthropy, the environment, local communities, and public policy are encoded into law. Other concerns—to varying degrees—may be accounted for (or ignored) elsewhere, such as in theoretical understandings of the corporation, business ethics, professional training, and shifting business norms.

Law and legal discourse have thus made a significant contribution to the quest for more responsible corporate conduct. But law is only one of many sources of influence on the corporation and,[3] as explained in this chapter, after abandoning a regulatory philosophy by the close of the nineteenth century, corporate law itself, along with mainstream corporate theory, has largely sidestepped full engagement with the ongoing cultural quest for enhanced corporate responsibility. Instead, corporate law has loosened, not tightened, constraints on those who govern corporations, and it fixates on investor welfare. With some exceptions, including occasional (failed) historical efforts to reform corporate governance by urging the adoption of a broader focus, and recent more successful benefit corporation statutes, corporate law's regulatory vacuum spurred an "outsourcing" of efforts to mandate responsible corporate conduct toward non-investor stakeholders to an array of *noncorporate* law regimes.

The disengagement of corporate law with corporate responsibility at a time when the corporation emerged as a potent socio-economic force can only be understood through a historical lens. Such a long view—briefly sketched—will highlight how the arrival of distinctive legal personhood for the corporation, although launching important and still-hot debates about the scope of corporate rights, did not likewise lead to corporate law paying heed to a broad-gauged *corporate* responsibility. Instead, the field turned inward, toward a preoccupation with *managerial* duties, which were then directed primarily toward shareholders and away from others. Eventually, mirroring a much earlier understanding of corporateness as simply an "aggregation" (or "nexus") of associated individuals, late twentieth century corporate theory (Easterbrook and Fischel 1991), under

[3] Many companies engage in socially responsible practices—by any measure—on a wholly voluntary basis, and in ways that exceed the demands of law. There is a vast literature on corporate social responsibility outside of law. An outstanding historical account is Goodpaster (2012).

the influence of financial economics, reinforced positive law's tightly-bounded focus on shareholders and managers and similarly ignored the corporate institution.[4] Ironically, then, corporate law and corporate theory have largely neglected the corporation itself as an influential social actor in its own right and have avoided the question of how it can best fulfill broader social expectations.

Part 2 describes how the recognition of distinctive legal personhood for the corporation in the late nineteenth century, while ushering in an array of essential and sometimes controversial rights for the corporation, brought as well inconclusive (and ongoing) debates about the nature of corporateness, along with heightened attention to corporate responsibilities. Part 3 explains how, with corporations increasingly pursuing private gain in the nineteenth century and not, as before, public purposes, the question of corporate purpose, that is, the basic question of for what and to whom is the *corporation* responsible, was not (and is not) even clearly addressed in corporate law, but has been left to the realm of business and social norms and practices. Instead, corporate law, as described in Part 4, focused on internal corporate governance, specifically on *managerial* responsibility and *managerial* fiduciary duties. With positive corporate law's deregulatory turn and inward emphasis, corporate law discourse only occasionally over history has addressed broader corporate responsibility issues and always—until recent benefit corporation statutes were enacted—has failed to bring broader corporate responsibility concerns "inside" the corporate governance system itself. Part 5 briefly describes how new theory in the 1980s bolstered this longstanding neglect and how, as a consequence of corporate law's paradigmatic bypassing of corporate responsibility, other legal regimes have supplied the key legal contributions to an ongoing social quest for more responsible corporate conduct, as that notion continues to evolve. Part 6 is a brief Conclusion suggesting that, by recovering the corporate institution as worthy of study as an important socio-economic institution in its own right, modern corporate law can address corporate responsibility as well as corporate governance.

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[4] For a discussion of how corporate law neglects the corporation as a critical institution in its own right, see Johnson (2016).

2. THE EMERGENCE OF THE CORPORATION AS A LEGAL, RESPONSIBLE PERSON

A. Legal Recognition of Corporate Personhood

As of 1780, colonial legislatures in the United States had chartered only seven business corporations. By 1800, only about 335 business corporations had been chartered by special legislative act, most in the last few years of the eighteenth century.[5] Many of these early charters were granted for inland navigation (turnpikes, bridges, canals), banking, or insurance enterprises; very few—eight—were for manufacturing companies. In the predominantly agricultural economy of the time, the corporation was a permitted organizational form used most often for public-serving businesses, as well as for colleges, hospitals, municipalities, and guilds.

Thus, the partnership form of business remained the standard vehicle of private gain-seeking business enterprise until well after 1840 (Chandler 1977: 36).[6] The partnership form was used in a broad array of businesses, whether small merchants and storekeepers offering goods and services locally or wealthy merchant bankers engaged in more far-flung commercial activity. Dramatic improvements in transportation technology (railroads during the 1840s) and later development of communication technology (the telegraph and telephone) permitted the dependable inflow of raw materials to, and the outflow of finished goods from, U.S. factories on an unprecedented scale (ibid. at 76–8, 82–6). Consequently, both the production and the distribution of goods such as textiles, glass, tin, and rubber products could, technologically, take place at much higher levels than before. Mass manufacturing could thus be combined with mass distribution within a single business firm with regional and national reach. And this was true whether such an industrial firm grew internally or by acquiring other smaller enterprises. In turn, large amounts of committed financial resources were needed for such capital-intensive endeavors, as well as a pre-arranged, centralized governance system that placed operational control in the hands of skilled managers.

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[5] *Citizens United v. FEC*, 130 S.Ct. 876, 940 n.53 (2010) (Stevens, J., concurring in part and dissenting in part).

[6] Today, interestingly, another noncorporate form of business—the limited liability company—has once again surpassed the corporation in popularity for newly formed, closely held businesses (Johnson 2011).

Business historians attribute the epochal rise of the corporation to its remarkable capacity to support these macro business trends (Blair 2003). The corporate form is a useful arrangement through which business is conducted because it facilitates the accumulation of vast (and committed) capital due to the divisibility of investor equity into numerous "shares" of corporate stock. Eventually, unlike the case with partnerships, legal rights to a significant degree resided with (or at least were based on) the "stock" itself, not the "stockholder."[7] Complex manufacturing enterprises also required people with specialized technical and managerial expertise, persons who very likely did not also provide most of the financial capital. Thus, the provision of capital *to* the corporation and the management *of* the corporation were distinct functions, which the corporate form facilitated. Limited liability, moreover, which began in New York in 1811 but developed haltingly, even into the early twentieth century (Horwitz 1992: 291 n. 165), largely immunized passive shareholders from business liabilities, unlike nineteenth century partnerships,[8] thereby inducing investor participation in potentially risky ventures they did not and could not control. Conversely, creditors of investors could not directly reach corporate assets, thereby effectively and efficiently partitioning such assets for access by business creditors only.

These distinctive features would make far greater legal and conceptual sense—not to mention linguistic simplicity—if a corporation were considered a person or entity distinguishable from both its investors and managers (Blair 2003). Nonetheless, before and after the turn of the twentieth century an intense academic debate over corporate personhood ensued, with some advocating precisely such an "entity" theory of corporateness in which the corporation was viewed as legally distinct from its constituents. Others, however, urged the "aggregation" theory in which corporations were viewed as mere aggregations of associated individuals (Millon 1990).

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[7] For example, within a corporation voting rights and the right to receive distributions from a corporation are rights associated with the shares of stock—which are alienable—whereas, within a partnership, voting rights are associated with the partner and, typically, are not alienable.

[8] Today, partnerships also may elect to provide general partners with limited liability, meaning they are not personally liable solely by reason of their partner status for partnership debts or obligations. See, e.g., Revised Unif. P'ship ACT § 306 (1996).

In 1886, the U.S. Supreme Court famously and tersely stated that a corporation was a legal "person for purposes of the Fourteenth Amendment."[9] Although a seemingly clear and authoritative pronouncement, the legal nature of a corporation, Professor Morton Horwitz argued, was not settled by the *Santa Clara* decision; rather, it remained as hotly contested after 1886 as it had been prior to that time (Horwitz 1992). In fact, the issue of what exactly is encompassed within the notion of corporate personhood continues to be highly pertinent to corporate rights and corporate responsibility in 2017, more than 130 years after *Santa Clara*. This relationship between, on the one hand, undoubted corporate personhood and, on the other hand, controversial corporate rights and responsibility, was seen most recently in the remarkable outcry over the Supreme Court's 2010 *Citizens United* decision that struck down federal campaign finance laws and held that corporations (and unions) enjoyed a First Amendment right to freedom of speech, including political speech,[10] and in the divided reaction to the Court's 2014 *Hobby Lobby* decision which upheld a business corporation's power and right to exercise religion.[11] If the issue of what exactly corporate personhood entails in the eyes of the law and larger society had truly been settled in *Santa Clara*, or at some point thereafter, such rulings should not have been unexpected or precipitated such controversy. Instead, sharp disagreement continues today over what rights and obligations should go along with modern understandings of corporate personhood.[12]

Historically, the emergence of distinctive corporate personhood has led to an ever-expanding, if still disputed, set of corporate rights. It includes rights that are, like free speech and free exercise of religion, constitutional in nature,[13] as well as the right to own and transfer property in forms separate from the property of shareholders, to enter and enforce contracts, to initiate and defend lawsuits, to advance unique business

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[9] *Santa Clara v. S. Pac. R.R. Co*., 118 U.S. 394 (1886).

[10] For an article placing *Citizens United* in historical context, *see* Avi-Yonah, (2010).

[11] *Burwell v. Hobby Lobby Stores, Inc*., 134 S.Ct. 2751 (2014).

[12] In early 2011, for example, the Supreme Court held that the "personal privacy" exemption in the federal Freedom of Information Act did not extend to corporations. *FCC v. AT&T, Inc*., 131 S. Ct. 1177, 1186 (2011).

[13] Corporations do not, however, have all of the constitutional rights of natural persons, lacking the Fifth Amendment's privilege against self-incrimination. *Hale v. Henkel*, 201 U.S. 43 (1906). Moreover, they obviously cannot hold office, adopt children, or marry.

goals, and so on, much like individuals.[14] The significance of corporate personhood goes far beyond the issue of corporate *rights,* however. Corporate personhood is immensely important to the subject of corporate *responsibility* as well. After all, if corporations are persons, then understandably they will be subjected to the growing number of laws regulating all persons—human and otherwise—in a rapidly industrializing, technologically transformed American economy. Thus, on the law side, corporations in their own stead must comply with criminal statutes, revenue laws, financial regulation laws, trade practice laws, and untold safety and public welfare legislation.

But the enormous socio-economic influence of the emergent industrial corporation generated as well abiding expectations of "responsible" corporate conduct that go beyond the demands enshrined in law. The conferring of rights on the corporation occasioned an insistence on a more demanding, if more elusive and vague, "corporate responsibility." And this is true in ways going far beyond the political and social implications of controversial legal rights such as corporate speech or corporate exercise of religion, as raised by those alarmed (or comforted) by the *Citizens United* and *Hobby Lobby* decisions. It goes to very basic concerns about what, apart from law compliance, corporations should recurrently do to be responsible citizens in a thriving economy.

The historical emergence of corporate personhood, reflecting the undeniable centrality of the corporation to the nation's economic growth and welfare, thus was seen to hold great promise for bestowing social good as well as potential peril for imposing social harm. The legal recognition of distinctive corporate persons—particularly in the case of the public corporation—represented a historically crucial acknowledgment that control over business enterprises, and their property and affairs, had solidified in the hands of directors and managers via a state-provided hierarchical governance framework, not in the hands of stockholders or other participants bound together in some amorphous, fully contracted-for, and egalitarian "association." Critically, the interests and goals of the business enterprise itself could not be simplistically equated with those of either investors or managers, or of any other associated persons, each of whose individual interests might be at odds with those of the others and the business itself, not to mention broader social interests.

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[14] For example, the Model Business Corporation Act confers on corporations the "same powers as an individual to do all things necessary or convenient to carry out its business and affairs." Model Bus. Corp. Act § 3.02 (2014).

Critics of corporate conduct—early on and today—were quick to point out that this new legal-social actor—the corporation—held the unprecedented power to impose unwanted externalities and inflict widespread, potentially uncompensated harm on employees, consumers, the environment, political contests, and others, thus raising financial and socio-political concerns. Proponents of corporations countered that corporations frequently exceeded the demands of law and conferred enormous social benefits reaching well beyond the gains accruing to capital providers and corporate managers. These include beneficial, life-enhancing transportation, communication, medical, pharmaceutical, recreational, and other useful and ever multiplying products and services, large numbers of jobs, taxes, civic leadership, and substantial charitable contributions. In short, the newfound (and ongoing) capacity both to inflict harm and produce benefits are two sides of the same corporate responsibility coin.

B. Inconclusive Theoretical Debates about Corporateness

Notwithstanding formal legal recognition of corporate personhood in the late nineteenth century—and continuing today—the nature of corporateness continued to be perplexing. Was it simply an aggregation of human individuals, who as beneficiaries of corporate success should bear the brunt of responsibility for corporate (mis)conduct—a position somewhat at odds with limited liability—and who alone should enjoy its derived rights? Or was it a genuinely separate socio-economic entity—whether "natural" or "artificial"[15]—distinct unto itself, with unique rights, and corresponding responsibilities, of its own (Mark 1987, Millon 1990)? Of course, the legal and philosophical tussle over the "true" nature of corporate personality, and who exactly should be "responsible" for corporate conduct, became meaningful only in light of the dramatic growth in the number of corporations—and their rising socio-economic prominence—throughout the nineteenth century and into the twentieth and twenty-first.[16]

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[15] For a modern acknowledgement of the "artificial" entity theory by a sophisticated business law court, see *In re Carlisle Etcetera*, 114 A.3d 592, 605–06 (Del. Ch. 2015) (describing concession theory).

[16] The debate over the nature and legal and moral significance of corporate personhood, like that of other social groups, continues today, whether couched in ontological terms or on pragmatic policy grounds (Johnson 2016).

Eventually, proponents of the entity theory prevailed[17] (Millon 1990), and corporations by and large were understood as conceptually (and legally) distinct from investors, managers, and other participants. Thought to be central to halting the decades-long wrangling over the nature of corporateness was a 1926 essay by philosopher John Dewey, who argued that the competing theories were infinitely malleable, with each capable of limiting as well as enhancing corporate power (Dewey 1926)—a position Morton Horwitz famously set out to refute[18] (Horwitz 1992: 68). The late nineteenth and early twentieth century debate over the nature of corporateness had taken on such urgency in the first place only because of what Horwitz describes as the "crisis of legitimacy in liberal individualism arising from the recent emergence of powerful collective institutions" (ibid.). Necessarily, those who controlled the governance of these mammoth organizations wielded vast and unprecedented social and economic power (Berle and Means 1932). Under corporate law rules as they ultimately developed, these control persons were not the stockholders, however, but a small handful of directors and professional managers.[19] Here, and in other ways too, the hierarchical rules governing the corporate form of business differed from those of a more egalitarian nature in the partnership form, where the general partners typically combined the capital-providing and management functions (Blair 2003), and bore personal legal responsibility for business wrongdoing.

As a result, the large numbers of investor-citizens who provided financial capital to corporate enterprises did not and could not, at least in public corporations with widely dispersed investors, directly control or manage corporate affairs to ensure appropriate responsibility toward others; nor could they easily monitor and rein in those who did manage. As corporations grew in socio-economic significance, therefore, those who managed them grew correspondingly in power, both in relation to investors and others associated with the enterprise as well as in external relation to society at large (Berle and Means 1932). Moreover, because the corporation ushered in a new era of big businesses, businesses on a

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[17] In the 1980s, however, the "aggregation" theory was rejuvenated in the form of a "nexus of contracts" theory of corporateness. *See* (Easterbrook and Fischel 1991); *infra* Part 5.

[18] For a nuanced and extensive response to Horwitz's "refutation," see Millon (1990).

[19] See, e.g., Model Bus. Corp. Act § 8.01 (2008) (stating that the business and affairs of a corporation are to be managed by or under the direction of its board of directors).

scale never seen before precisely because of the unusual law-conferred features noted above, the “regulation of business became the paramount domestic issue in American politics in the early twentieth century.” (Chandler 1988: 425). Contending with the phenomenon of big business meant, necessarily, contending with the phenomenon of its handmaiden, the corporation.

The key point with respect to the relationship of corporate personhood and corporate theory to the history of corporate responsibility is that all of these corporation-centered technological, legal, and intellectual currents flowing into the twentieth century set the stage for ensuing corporate responsibility debates.[20] (Goodpaster 2012). At the heart of these discussions was a return to the issue of whether, to some degree, corporations should once again be regarded as public-serving or at least, in modern parlance, “socially responsible,” not simply vehicles for private gain. These decades-long debates, which continue today, necessarily drew on, presupposed, and significantly benefited from the clear emergence of a legally and conceptually distinct corporate person. After all, it is *corporate* responsibility that emerged in the twentieth century as a topic of ongoing social concern. This took for granted that the corporation was now a meaningful social and legal actor in its own right, distinguishable from its diverse constituents, and possessing both unique rights and responsibilities. Within corporate law, however, a very different course was charted.

3. CORPORATIONS PURSUE PRIVATE GAIN, NOT PUBLIC PURPOSE: CORPORATE LAW’S INWARD, DEREGULATORY TURN AWAY FROM CORPORATE RESPONSIBILITY

The keen twentieth century interest in the social responsibility of the corporation was a natural offshoot of an earlier era of corporate history. Prior to the nineteenth century, many corporations were charged with carrying out public-serving functions.[21] (Horwitz 1992). This public service dimension seems not to have been an express legal prerequisite to

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[20] Unlike corporate law scholars, business ethicists and other business school scholars pay a great deal of attention to corporate responsibility.

[21] Justice Stevens emphasized this history in his opinion in *Citizens United v. FEC*, 130 S. Ct. 876, 949 (2010) (Stevens, J., concurring in part and dissenting in part).

corporate formation but instead reflected in actual chartering practice a shared belief about the proper focus of corporate activity. Thus, early in American history, colleges, hospitals, and municipalities were often organized as corporations, as were such public-serving business ventures as canals, turnpikes, and banks.[22] In short, there appears to have been a correlating of corporateness with public-oriented service of a sort that did not exist with business activity more generally.[23]

An illustrative statement of the early public-serving expectation about corporateness can be seen in a 1809 Virginia Supreme Court opinion affirming the legislative chartering of an insurance company. Specifically, the court noted the following:

> They ought never to be passed, but in consideration of services to be rendered to the public … . It may be often convenient for a set of associated individuals, to have the privileges of a corporation bestowed upon them; but if their object is merely *private* or selfish; if it is detrimental to, or not promotive of, the public good, they have no adequate claim upon the legislature for the privileges.[24]

In this passage, the court twice referred to the privileges of corporate status and twice to the element of public service. This judicial opinion exemplifies the early nineteenth century belief that there was no inherent legal right to carry on private business for purely private gain in the corporate form.

By the time of the 1819 Supreme Court decision in *Dartmouth College v. Woodward*,[25] this public-service conception of corporateness was in apparent decline even as the chartering of business corporations was on the rise and moving from special legislative act—fraught with monopoly

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[22] Ibid. at 926 (Scalia, J., concurring).

[23] Ibid. at 949 n.53 (Stevens, J., concurring in part and dissenting in part).

[24] *Currie's Admin. v. Mut. Assurance Soc'y*, 14 Va. (4 Hen. & M.) 315, 437–48 (1809). Interestingly, the court referred to "associated individuals"—as did the majority in *Citizens United*—yet, the Virginia Supreme Court still insisted that such a conception of corporateness supported a public-serving function. The Virginia Bill of Rights of 1776 was explicit that "no man, or set of men, are entitled to exclusive or separate emoluments or privileges from the community but in consideration of public services." This provision was applied to corporations in the 1809 decision by the Virginia Supreme Court.

[25] *Trs. of Dartmouth Coll. v. Woodward*, 17 U.S. (4 Wheat) 518 (1819). Chief Justice Marshall still described corporate grants as "deemed beneficial to the country," ibid. at 637, but the linkage between charters and promoting public purposes was rapidly dissolving.

privilege and cronyism—to general incorporation laws. An abiding societal concern with responsible corporate behavior by no means disappeared with the decline of public-serving corporations and the rise of general incorporation laws, however, but instead found fuller expression in strict regulation of corporations. In the early and mid-nineteenth century, moreover, this regulation took place within corporate law itself.

For example, states typically limited the amount of capital a single corporation could assemble ($500,000 to $1,000,000); restricted the scope of corporate powers and purposes; limited the duration of a corporation to a period ranging, generally, from 20 to 50 years; placed limits on company indebtedness; prohibited the holding of stock in another corporation; and gave stockholders the power to remove directors at will and exercise broad veto powers over proposed transactions. These strictures, Justice Louis Brandeis noted in a famous dissenting opinion,[26] eventually fell away as several states—most notably, New Jersey in the late nineteenth century and then Delaware—eagerly vied for new corporate charters, an important source of state revenue, by adopting a low cost and deregulatory philosophy of corporate law in which legal restrictions were curtailed and corporate powers were enhanced. This so-called "race" was famously, and distressingly, described by Brandeis as being one "not of diligence but of laxity."[27] His Depression-era opinion chronicles in detail how a largely suspicious and regulatory stance toward corporations gradually subsided by the turn of the twentieth century, crumbling for good in 1899 when Delaware famously adopted its new and lax general incorporation statute in a successful effort to poach the chartering business from frontrunner New Jersey, which later sealed its fate by briefly adopting a renewed (and failed) regulatory philosophy.[28]

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[26] *See Liggett v. Lee*, 288 U.S. 517, 542–60 (1933) (Brandeis, J., dissenting).

[27] *Liggett*, 288 U.S. at 560. Over the last quarter of the twentieth century, the "race" debate broadened to include arguments that, contrary to Brandeis' view, the race was to the "top" or to "nowhere." (Bratton 1994).

[28] After New Jersey relaxed its corporation statute in 1896—by, for example, permitting corporations to own stock in other corporations and allowing them to engage in any lawful business activity—it saw a remarkable upsurge in the chartering of new corporations. These developments curbed the troubling ultra vires doctrine and facilitated corporate mergers and consolidations. In 1913, however, shortly after Governor Woodrow Wilson became President, New Jersey passed "The Seven Sisters Acts" that greatly curtailed corporate powers. Although most of the provisions were soon repealed, Delaware had already gained an unrivaled lead in corporate chartering, and New Jersey had forever lost the corporate "race" to Delaware (Seligman 1976).

Thus, at the start of the twentieth century, corporations not only were economically powerful and regarded as legally distinct from their associated persons, they could (but were not required to) exclusively pursue private gain, not public good; they were not closely regulated (as before) by state corporation statutes; and corporate statutes themselves said nothing about what purposes a corporation can or should pursue; all features that continue today. Instead, corporate statutes, then and now, establish a governance framework that broadly empowers a corporation's board of directors to chart corporate activities free of state regulation and with limited shareholder input. In short, the statutes did not regulate, they enabled. The consequences of this dramatic deregulatory development in corporate law for concerns about corporate responsibility in light of growing corporate socio-economic influence were three-fold. First, there was a turn in corporate law toward debates, not about *corporate* obligations, but about *managerial* duties. Second, there were occasional, generally failed, efforts to achieve corporate responsibility by directly reforming the corporate governance system itself. Only recent benefit corporation legislation has modestly succeeded in this reform strategy. Third, regulation of the corporation itself moved entirely outside the area of corporate law and into a wide swath of other legal regimes, a trend that continues today. The first two developments are discussed in Part 4 below, and the third is described in Part 5.

4. FIDUCIARY DUTY DEBATES AND CORPORATE GOVERNANCE REFORM EFFORTS

A. Fiduciary Duty Debates

The deregulatory turn in corporate statutory law in the early twentieth century, precisely as the corporation achieved distinctive legal stature and grew more influential, led corporate law scholars and corporate reformers to address corporate responsibility by focusing on the proper objects of managerial duties. In other words, rather than addressing the obligations of the business itself, corporate law discourse emphasized the duties of those who governed the business. This effort centered around judge-made fiduciary duties because corporate statutes did little to constrain managers. The seminal debate was between Professor Merrick Dodd and Professor Adolf Berle in the early 1930s (Berle 1932a, Berle 1932b, Dodd 1932). Dodd argued that corporate managers should acknowledge the reality of far-reaching corporate influence and responsibly advance a broad range of nonshareholder "corporate" interests, as well as those of

shareholders,[29] while Berle countered that corporate managers should use their control over corporate affairs solely to benefit shareholders, reasoning that Dodd's position gave managers unacceptably broad discretion that reduced their accountability.

Although Berle eventually conceded that Dodd's view had prevailed, in light of the 1953 New Jersey Supreme Court ruling broadly upholding corporate philanthropy,[30] in fact the concession was premature because the debate has continued, feverishly so,[31] and two key points about this debate over managerial responsibility remain true today. First, no corporate statute requires that corporate directors maximize profits or shareholder wealth (Elhauge 2005). Instead, directors are charged to act in the "best interests of the corporation."[32] Moreover, like the Delaware Supreme Court,[33] the American Law Institute's Principles of Corporate Governance prescribe only an "enhancing" of shareholder wealth, not its maximizing, and permit directors to consider an array of humanitarian, educational, public welfare, and philanthropic interests when making decisions (ALI 1994). And outside of Delaware, a majority of states have enacted so-called constituency statutes (Cox & Hazen 2010: 245). These laws permit, but do not require, directors to consider the interests of nonshareholders such as employees, consumers, suppliers, and local communities in steering corporate activity.

Second, there is very little case law clearly specifying whether corporate directors may (or may not) take a broad view of their

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[29] Dodd observed that if the "corporate body is real … managers of the unit are fiduciaries for it and not merely for its individual members." (Dodd 1932: 1160).

[30] *Smith v. Barlow*, 98 A.2d 581 (N. J. 1953).

[31] Writing in 1992, then Delaware Court of Chancery Chancellor William Allen contrasted the shareholder primacy approach emphasizing investor interests with the more encompassing corporate social responsibility view. Chancellor Allen noted that courts had no "clear guide" for resolving that debate and had generally tried to dissolve any conflict and reconcile shareholder interests with noninvestor interests by invoking the amorphous and unknowable "long term interest" of the firm (Allen 1992: 272, 275).

Numerous contemporary corporate law scholars have continued to debate, and disagree on, this important issue (Johnson 2016). Professor Harwell Wells argues that the post-1930s debates about corporate responsibility among legal scholars simply recapitulate the Berle-Dodd debate in somewhat altered form (Wells 2002).

[32] See, e.g., Model Bus. Corp. Act § 8.30.

[33] *Paramount Comm., Inc. v. Time, Inc.*, 571 A.2d 1140, 1150 (Del. 1990) (specifying a director duty to enhance "corporate" profitability).

responsibilities by considering the impact of corporate action on non-investors such as employees (Johnson 2016). Although scholars today divide over whether judge-made law adopts a default rule permitting such a broad focus, rather than demanding a narrow focus on maximizing financial returns, (ibid.) the law's enduring vagueness and agnosticism reflect judicial restraint in not resolving an issue many think is best left to the realm of business practices and evolving social norms, if not the legislative arena. Thus, case law has refrained from definitively settling the divergent views of managerial duties first articulated by Berle and Dodd. The strong judicial deference given to directors by courts through the business judgment rule bolsters this judicial ambivalence about managerial responsibilities.[34] This remains the case notwithstanding a famous 1970 observation by economist Milton Friedman that the social responsibility of corporate managers is to maximize profits (Friedman 1970). Professor Friedman's remark expressed a normative position with which many observers agree—and with which many others disagree—but it did not accurately reflect law's more permissive stance on that important question.

The significance for the history of corporate responsibility is that neither statutory nor decisional law requires a narrow or broad *corporate* purpose nor a narrow or broad *managerial* fiduciary duty focus, but instead leaves those issues to the larger realm of evolving norms and practices, to be resolved in various ways by different companies. Concern that such legal indifference permitted too little managerial attention to matters of corporate responsibility—and allowed too strong a focus on purely financial returns due to factors such as investor voting rights and, later, short-termism and skewed managerial compensation incentives—led to various reform efforts aimed at more fundamentally altering the internal decision-making structure of corporations.

B. Corporate Responsibility by Reforming Corporate Governance

Frustration over the inconclusive debate spurred by Berle and Dodd as to the proper fiduciary focus for directors—shareholders only or a broader group of stakeholders—prompted occasional, quite provocative but largely unsuccessful, efforts by Dodd sympathizers to reform the deep decision-making architecture of corporate governance as a possible path

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[34] See, e.g., *Shlensky v. Wrigley*, 237 N.E.2d 776 (Ill. App. Ct. 1968) (deferring to management as to how an expressed concern for the neighborhood surrounding a baseball stadium may enhance long-term shareholder interests).

to more responsible conduct. With recent benefit corporation statutes, however, modest change was achieved.

1. Mid-twentieth century

One proposed governance reform that surfaced periodically—and that would serve to institutionally flesh out a suggestion made by Professor Chayes—was the suggested use of "public interest" directors on corporate boards (Chayes 1959). These persons, in theory, would take a broader-gauged view of how a corporation's activities affected groups other than investors.[35] As noted by Professor Douglas Branson, the 1870s reorganization of the Union Pacific Railroad board and the late twentieth century board of the Communications Satellite Corporation included public interest directors (Branson 2001: 613). Justice William Douglas in 1940 (Douglas 1940: 52–3), and other commentators since then (Stone 1976: 157–73), also have advocated for public interest directors. Unlike certain European nations providing for employee representation on supervisory boards (Vagts 1966), however, changing the composition of the board of directors from a completely stockholder-elected body to one more broadly representative of other groups never took hold in the U.S. with respect to solvent companies.[36] Today, only common stockholders enjoy statutory suffrage under American corporate law.[37]

Other noteworthy proposed reforms of corporate governance during the 1970s included Professor William Cary's advocacy of federal minimum standards for large corporations and Ralph Nader's (and his coauthors') proposal for outright federal chartering of corporations (Branson 2001). Concerned about what Justice Brandeis had called a "race of laxity,"[38] and that he branded a "race to the bottom," Professor Cary believed that

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[35] One problem with "special constituency" directors—including "public interest" or employee- or creditor-elected directors—is that all directors have fiduciary duties demanding that they place the interests of the beneficiary of those duties above all other considerations. If those duties run only to the "corporation," a "special interest" director must advance the corporation's interests, not those of his or her electors. If the duties also run to stockholders, their interests must be paramount. Thus, either the special interest director must argue that advancing the interests of his or her special constituency is consistent with and advances corporate and/or stockholder well-being, or that constituency's interests must remain subordinate (Sepe 2013).

[36] For financially distressed companies, creditors, including unions and the federal government, may have a role in selecting directors (Sepe 2013).

[37] *See,* e.g., Del. Code Ann. tit. 8, §§ 211, 216 (2013).

[38] *Liggett v. Lee*, 288 U.S. 517, 559 (1933) (Brandeis, J., dissenting).

Delaware corporate law had degenerated so far in a deregulatory direction as to have become too pro-management and anti-shareholder in orientation (Cary 1974). The solution proposed by Cary was to establish mandatory federal "minimum standards" that would preempt more lax state law rules on certain key subjects. (ibid.). Cary's proposal did not fundamentally alter the board-centered model of corporate governance, however, nor its focus on protecting investor interests. It sought only to ensure that such a model adhered to certain standards imposed by federal law because, Cary believed, interjurisdictional competition among states had produced intolerably low corporate law standards. Thus, from a broad corporate responsibility perspective, Professor Cary's proposal was, as a substantive matter, quite modest. Beyond generating considerable scholarly attention, however, the proposal at the time went nowhere, although the landmark 2002 Sarbanes-Oxley Act and the 2010 Dodd-Frank Act embody the principle of federal standards sought long ago by Cary.[39]

More ambitious was the federal chartering proposal. Nader and his coauthors believed that the largest U.S. corporations should be chartered by the federal government, not states, because, they reasoned, under state law managers were not sufficiently attentive either to investor interests or those of other constituencies (Nader et al. 1976). Moreover, Nader and his coauthors believed that such a federal corporate law should be more overtly regulatory in philosophy—as corporate law had been early in American history—and should mandate public interest directors who would advance employee, consumer, and community welfare, as well as heightened responsibility to stockholders. Furthermore, their proposal required a certain amount of periodic social auditing and reporting (Branson 2001: 616). Corporations, under this proposal, also would have only limited duration, not perpetual—reverting on this point to early nineteenth century law—and they would have to renew their charters every 20 or 25 years (ibid.). Like Professor Cary's proposal, Nader's ideas generated scholarly commentary. Unlike Cary's proposal, it also resulted in several congressional hearings (ibid.). His proposals never went beyond that, however.

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[39] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified at 15 U.S.C. § 7201 *et seq.*) (2012); Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, 124 Stat. 1376 (codified as amended at 12 U.S.C. §§ 5301–5641) (2012).

2. Early twenty-first century

Since corporate law's deregulatory turn over the course of the nineteenth century, the most extensive regulatory initiatives touching on corporate governance were not enacted until the first decade of the twenty-first century. These were the landmark Sarbanes-Oxley Act of 2002,[40] the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank"),[41] and the benefit corporation statutes that first appeared in 2010 and rapidly spread.

a. Sarbanes-Oxley The Sarbanes-Oxley Act ("SOX") grew out of the numerous corporate frauds revealed at such brand name companies as Enron, Tyco, WorldCom, HealthSouth, and many others (Johnson and Sides 2004). SOX took a smorgasbord-like approach to regulating corporate conduct, touching on a number of areas, such as inbred conflicts of interest of public company auditors and security analysts, and improving financial disclosures by corporations. Importantly, SOX also addressed in unprecedented fashion certain corporate governance subjects, which historically had been left to state corporate law, notwithstanding the provocative but ill-fated proposals noted earlier. For example, SOX imposed new responsibilities on the audit committee and required greater independence of committee members, prohibited corporate loans to officers, enhanced requirements for officer certifications of periodic financial reports, provided for forfeiture of certain bonuses and profits in connection with restatements of financial statements, and required management to assess and report on the quality of internal controls (ibid.: 1155–85).

SOX also corresponded with rapid growth in the promulgation of "soft law" associated with corporate activity. Corporations voluntarily adopted stronger internal codes of conduct (i.e., codes of ethics) for all employees, board committee charters specified member responsibilities in greater detail, and corporate boards sought to voluntarily conform to various governance metrics of "best practices." In addition, guidelines and principles were elaborated to guide corporate behavior in a host of areas such as risk management and regulatory compliance functions, and different indexes and ratings were developed to assess the soundness of various corporate practices (Bhagat 2008). These nonbinding initiatives

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[40] Sarbanes-Oxley Act of 2002, Pub. L. No. 107–204, 116 Stat. 745 (codified at 15 U.S.C. § 7201 *et seq.*) (2012).

[41] Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111–203, 124 Stat. 1376 (codified as amended at 12 U.S.C. §§ 5301–5641) (2010).

did not have the legal "bite" of positive law, but they served to alter the evolving normative expectations as to what responsible corporate conduct should look like in the twenty-first century. Moreover, by voluntarily adopting them corporate directors and managers likely sought to ward off yet additional legal regulation while also signaling that they were "responsible" actors.

b. Dodd-Frank The Dodd-Frank Act, like SOX, extended federal law into what was traditionally considered the province of state corporate law. For example, under that Act public companies must give shareholders a periodic nonbinding advisory vote on executive compensation ("say on pay");[42] all the members of a company's compensation committee must be independent;[43] disclosure of the relationship between executive compensation and financial performance ("pay for performance") must be made;[44] the SEC was authorized to craft rules giving shareholders greater access to the company's proxy statement to advance shareholder nominees for membership on the board;[45] and disclosure is required as to whether, and why if so, a company has selected the same person to serve as chair of the board of directors and chief executive officer.[46] Also, in an effort to encourage the reporting of corporate wrongdoing, Dodd-Frank strengthened whistleblower incentives. Under this provision, from 10 to 30 percent of a monetary recovery may be paid to someone who provides "original information" leading to successful prosecution of an SEC enforcement action that results in a sanction exceeding $1 million.[47]

These two federal regulatory efforts undoubtedly evince profound frustration with state corporate law's ongoing resistance to meaningful attention to corporate responsibility and reform. Nonetheless, they largely focus on better protecting investor interests, not safeguarding broader interests. Thus, however unprecedented the recent federal incursions into corporate governance might be, in fact they continue the longstanding failure to address broad corporate responsibility by means of corporate governance reform.

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[42] Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, § 951, 124 Stat. 1376 (codified as amended at 12 U.S.C. §§ 5301–5641) (2010).

[43] *See* ibid. § 952.

[44] Id. § 953.

[45] *See* ibid. § 971.

[46] *See* ibid. § 972.

[47] Ibid. § 922.

c. Benefit corporation legislation Corporate governance, even after the noted federal reforms, remained a closed system of just three groups—investors, directors, and managers. In addition, recent shareholder, particularly hedge fund, activism in the public corporation arena, coupled with shareholder voting rights that can be used to remove directors from office, exerts great pressure on directors and managers to accommodate shareholder concerns. Thus, many corporate responsibility initiatives, in responding to felt social pressures and being designed for favorable public relations, while also placating investors, often are couched as being in both nonshareholder and shareholder interests, as managers supposedly seek to "do well by doing good." Most such public company social responsibility efforts today, and historically, either are entirely voluntary or mandated by very specific noncorporate laws of the type described below in Part 5. With respect to private companies, however, which do not face the intense capital market or shareholder and public relations pressure experienced by public companies, legislation first enacted in 2010 offered a new type of business corporation model that combines profit-seeking with the pursuit of one or more "public benefits" of a more socially responsible nature. Already, a majority of states have authorized these new companies.[48]

These so-called "benefit corporations" are opt-in, hybrid forms of business. They are "for profit" businesses that, while pursuing profits, do not seek to maximize profits and, in addition, they must identify and pursue a general or specific public benefit. The general public benefit might be to advance an overall social or environmental objective, while specific benefits, in Delaware for example, can be for the business to have a positive effect of an artistic, charitable, cultural, economic, educational, literary, medical, religious, scientific, or technological nature.[49]

As to director duties, the statutes explicitly provide that the focus is not solely on investor welfare. Instead, directors are required to more broadly consider (or balance) the effects of any corporate action (or any decision not to act) on a variety of stakeholders. Thus, in contrast to the constituency statutes described earlier, which simply permit director

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[48] *See State by State Legislative Status*, Benefit Corp. Info. Ctr., http://www.benefitcorp.net/state-by-state-legislative-status (last visited May 30, 2016).

[49] *See, e.g.*, Del. Code Ann. tit. 8, § 362(b). Laureate Education, Inc., the largest global network of degree-granting educational institutions, is a Delaware benefit corporation that also recently conducted a public offering of securities (Westerhouse 2016).

consideration of various stakeholder interests, benefit corporation statutes mandate it.

These statutes seek to broaden the interests to be advanced by companies themselves and to be considered by directors in formulating corporate strategy and action. For the first time since state corporate law in the nineteenth century abandoned the expectation that corporations would serve a public purpose and, instead, to compete with other law-producing states, adopted a deregulatory approach, these new corporation laws address corporate responsibility through modestly reforming the inner corporate governance system of business companies. Moreover, benefit corporations alter the larger tenor of corporate discourse by combining the pursuit of profits with the advancement of a public purpose within the business corporation. Whether a significant number of start-up ventures will utilize this novel form of corporation, and whether it will impel or hinder changes in the social responsibility practices of regular business corporations, remains to be seen. In the meantime, much of law's effort to achieve more responsible corporate conduct comes from an eclectic array of rules regulating the "external" conduct of corporations as described below.

5. CORPORATE RESPONSIBILITY FROM OUTSIDE CORPORATE LAW

Reinforcing traditional corporate law's internal focus on investor well-being, corporate theory in the last two decades of the twentieth century revived an earlier, individualistic, "aggregation" conception of the corporation that in fact disaggregated and disregarded the corporation. The reemergence of the so-called "nexus of contracts" theory, imported from financial economics, had decided counter-ramifications for corporate responsibility in ways that are still unfolding. The theory does not—it cannot—deny the established doctrine that the corporation is a legal person distinct from its various constituencies. Thus, the theory fully accepts that the corporation has many (though not all) human-like features, including specified legal rights and responsibilities, in its own capacity and separate from those of its various constituencies. But at the same time, this undoubted legal person is considered to be, descriptively, a mere web or network of contractual relationships between and among various individuals, such as investors, managers, employees, customers, creditors, suppliers, and so on (Easterbrook and Fischel).

The corporation, in short, is formally acknowledged but quickly disaggregated and ignored as a meaningful institution in its own right.

Normatively, moreover, this theory makes shareholders the exclusive beneficiary of fiduciary duties, and thus provides intellectual support for the strong norm of shareholder primacy that has gripped public corporations over the last 30 years. This explains why, today as throughout most of the twentieth century, concerns about corporate responsibility continue to find legal expression in the vast "external" regulation of the corporation, not in the deep penetration of those concerns into the very heart of corporate law theory and governance, even though governance failures rather regularly radiate outward with devastating consequences on so-called "third parties," as seen in the financial disasters leading to the enactment of SOX and Dodd-Frank.

Viewed historically, the emergence of corporate personhood, corporate law's and corporate theory's long and continuing neglect of corporate responsibility, the vast scale on which the corporation permitted business to be conducted and exert broad influence, and an investor-centered, private gain-oriented business norm, coalesced in an upsurge in calls for heightened legal regulation of the corporation that began in the late nineteenth century and continues to the present (Novak 2010). Thus, for example, beginning in 1890, the Sherman Antitrust Act,[50] followed by the Elkins Act of 1903 and the Mann-Elkins Act of 1910,[51] the Clayton Antitrust Act of 1914,[52] the Robinson-Patman Act of 1936,[53] and other trade regulation laws, outlawed monopolies, price fixing, and other predatory and anti-competitive business practices. On the food and drug safety front, in 1906, the Pure Food and Drug Act was adopted and the Food and Drug Administration was created.[54] Numerous worker protection laws were enacted to prohibit child labor,[55] provide workers

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[50] Sherman Antitrust Act, ch. 647, 26 Stat. 209 (1890) (codified as amended at 15 U.S.C. §§ 1–17 (2012)).

[51] Elkins Act, ch. 708, 32 Stat. 847 (1903); Mann-Elkins Act, ch. 309, 36 Stat. 539 (1910).

[52] Clayton Antitrust Act, Pub. L. No. 63-212, 63 Stat. 730 (1914) (codified as amended at 15 U.S.C. §§ 12–27 (2012)).

[53] Robinson-Patman Act, Pub. L. No. 74-692, 49 Stat. 1526 (1936) (codified as amended at 15 U.S.C. § 13 (2012)).

[54] Pure Food and Drug Act, Pub. L. No. 59-384, 34 Stat. 768 (1906) (repealed by Federal Food, Drug and Cosmetic Act, ch. 675, § 902(a), 52 Stat. 1040, 1059 (1938), establishing the Food and Drug Administration).

[55] Fair Labor Standards Act of 1938, Pub. L. No. 75-718, 52 Stat. 1060 (codified as amended at 29 U.S.C. § 201–219 (2012)).

compensation insurance,[56] mandate a minimum wage,[57] establish a 40-hour work week,[58] prohibit discrimination on the basis of gender[59] and age,[60] and provide other employee safeguards.

Consumers were given an array of product safety, credit protection, credit reporting, and debt collection protections from objectionable corporate business practices,[61] and emissions into the environment were regulated by means of the Clean Air Act[62] and the Clean Water Act.[63] In addition, investors have been protected through bolstering mandatory disclosures to them by companies seeking capital and in providing specified information to investors in public companies on an ongoing basis.[64] These assorted laws are just a few examples of the myriad federal, state, and local laws regulating corporations to make them comply with evolving notions of responsible business practices, many of which laws are viewed in the business sector as costly and unnecessary government control of private business.

6. CONCLUSION

Corporate law, long ago, essentially "outsourced" concerns about corporate responsibility to other bodies of law. The result, from the late

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[56] Longshoremen's and Harbor Workers' Compensation Act, Pub. L. No. 69-803, 44 Stat. 1424 (1927) (codified as amended at 33 U.S.C. §§ 901–950 (2012)).

[57] See *supra* note 55; Fair Minimum Wage Act of 2007, Pub. L. No. 110-28, 121 Stat. 112 (codified at 29 U.S.C. § 206 (2012)).

[58] See *supra* note 55.

[59] Equal Pay Act of 1963, Pub. L. No. 88-38, 77 Stat. 56 (codified as amended at 29 U.S.C. § 206(d) (2012)).

[60] Age Discrimination in Employment Act of 1967, Pub. L. No. 90-202, 81 Stat. 602 (codified as amended at 29 U.S.C. §§ 621–624 (2012)).

[61] Consumer Product Safety Act, Pub. L. No. 92-573, 86 Stat. 1207 (1972) (codified as amended at 15 U.S.C. §§ 2051–2084 (2012)); Poison Prevention Packaging Act of 1970, Pub. L. No. 91-601, 84 Stat. 1670 (codified as amended at 15 U.S.C. §§ 1471–1476 (2012)).

[62] Clean Air Act, Pub. L. No. 88-206, 77 Stat. 392 (1963) (codified as amended at 42 U.S.C. §§ 7401–7671 (2012)).

[63] Clean Water Act, Pub. L. No. 92-500, 86 Stat. 816 (1972) (codified as amended at 33 U.S.C. §§ 1251–1387 (2012)).

[64] Securities Act of 1933, Pub. L. No. 73-22, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a–77aa (2012)); Securities Exchange Act of 1934, Pub. L. No. 73-291, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a–78pp (2012)).

nineteenth century and on, has been a tightly cordoned purview for corporate law on the corporate responsibility front and an ever widening ambit for a host of other laws. The corporation itself was economically productive and socially useful and, given that the chartering of corporations became a lucrative source of revenue and was a state, not federal, law matter, inter-jurisdictional competition led to a relaxing, not stiffening, of corporate law. This trend can be seen today, for example, as Nevada vies with Delaware through lenient laws quite favorable for directors and managers, just as Delaware competed with New Jersey long ago.

Acknowledging the pivotal role and influence of the corporation, law generally has recognized its distinctive legal personhood as well, conferring various rights on it even as numerous sectors of society correspondingly demanded that it discharge various responsibilities, either voluntarily or by fiat. State corporate law, on the other hand, by focusing on the “inside” of the corporation in an effort not only to attract companies but also to balance strong managerial authority with accountability to shareholders (Bainbridge 2008), ignored the corporate institution itself as an object of study and regulation, and thus neglected the subject of corporate responsibility. Corporate theory in the late twentieth century reinforced this disaggregative approach to the corporation. Yet, precisely because corporations as distinct legal and socio-economic actors can and do have institutional *purposes* separate and apart from those of their shareholders and other constituencies, they likewise have *responsibilities* in their own right. Only as corporate law attends to the array of pluralistic goals made possible by the corporation (Johnson 2016), will it likewise attend to the corporation’s concomitant responsibilities.

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22. Evolutionary models of corporate law

Amitai Aviram

"Facts are like beads" said the sociologist Werner Sombart, "they require a string to hold them together." [Sombart (1929):5]. This string, the "unifying idea" as Sombart called it, is the theoretical model.

This chapter explores evolutionary models of the development of corporate law. Evolutionary models are models that assume the explored events are significantly determined by competition between various actors over resources. Such models assume that actors who "win" the competition gain more resources and increase their proportion in the actor population, while actors who "lose" and lack resources are either eliminated or at least become less common in the actor population.

Because competition, both between individuals and between groups, is a dominant feature of social interaction, and because law is a product of social interaction that both affects competitors and is used by competitors to gain advantage over rivals, evolutionary models are useful in legal scholarship.

In particular, such models are useful when the scholarship explores changes in the law. Thus, evolutionary models of legal development are often useful in comparative law (which primarily explores change over space) and in legal history (which primarily explores change over time).

This chapter examines the use of evolutionary models to explain the historical development of corporate law. Section 1 explains the tension between evolutionary models (and other theoretical models that apply beyond a specific time and space) and the empirical study of legal history. The relationship can be symbiotic, but fundamental differences in the goals of legal history and evolutionary modeling (and, perhaps, in the incentives of historians vs. modelers) make cooperation tenuous.

Section 2 explains the main features of evolutionary models in general, and how those features apply to the evolution of law. Sections 3–5 examine the family of evolutionary models that is most used in the literature to explain the development of corporate law: regulatory competition.[1] Each section examines one model in the family: horizontal,

[1] Regulatory competition models explain changes to corporate law in recent decades. They are not as useful in explaining the evolution of business

vertical, and intrastate. Section 6 concludes with a revised intrastate model that (I argue) better explains a dominant feature of American corporate law: the resilience of Delaware's dominance.

1. WHY DO LEGAL HISTORIANS NEED EVOLUTIONARY MODELS?

Legal history is an empirical endeavor, and it has a complicated relationship with models of law development. Some historians find modeling history to be a "research fetish" focused on validating models rather than exploring the past: "The champions of model-based economic history all too frequently allow their enthusiasm for economic theorems and statistics to soar dangerously at the expense of arduous and time-consuming research on the institutional, legal, social and political aspects of a historical context." [Cipolla (1991):69]

Indeed, some historians reject any theory that applies beyond the particular time and place they study, and thus reject all (generalizable) models. For example, in the preface to his book THE EMPEROR IN THE ROMAN WORLD, Fergus Millar states:

> In preparing the work I have rigidly avoided reading sociological works on kingship or related topics, or studies of monarchic institutions in societies other than those of Greece and Rome … For to come to the subject with an array of concepts derived from the study of other societies would merely have made even more unattainable the proper objective of the historian, to subordinate himself to the evidence and to the conceptual world of a society in the past. [Millar (1977):xii; cited in Cipolla (1991):67]

Yet history (in the sense of the empirical project of representing the past) and models need each other. Models make two important contributions to history. The first is identifying the most significant empirical facts

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organizations over centuries, because the political and constitutional framework that underpins regulatory competition changes greatly over such timeframes. Modeling change in the law of business organizations over the very long term would likely focus on an increase in firm scale and capital intensity (using more capital as labor costs increase), resulting in a need to access more capital, in turn resulting in enhanced transferability of equity and debt, and finally in governance structures that mitigate agency problems caused by this enhanced transferability. Such models are not evolutionary; i.e., they do not explain outcomes as a result of competition among a set of actors. Therefore, I will not discuss these models here.

necessary to represent the past. In other words, identifying the main variables that explain the particular past events that the historian is exploring (including subjective outcomes, such as narratives and intellectual frameworks). Without prioritizing the facts that best explain the explored events, the historian would not be able to focus her research on a manageable set of facts.

Second, models identify what research questions should be asked. They do so by hypothesizing the way in which each of the variables affects the explored events and the other variables. This is done by fixing certain assumptions and then demonstrating that, if the assumptions hold, there would be a particular logical relationship between the variables and the explored events. The assumptions need not (and cannot) be ubiquitously *correct*; they only need to be *useful*. [Box (1979):202: "All models are wrong but some are useful."]

A good model is as simple as possible while correctly identifying the relationship between the variables and the outcomes *most of the time*. Equipped with a model, the empirical project is directed to particular research questions: the validity of the causal relationship between the variables and the explored events, and the validity of the assumptions made by the model.

Though legal history and models of law development benefit from each other, they both have alternatives. Models can be tested through experimentation rather than through studying past cases. And history can rely on non-generalizable "models," designed ad hoc for a particular explored event. Non-generalizable models do not aim to explain or apply to other periods or places, but merely to identify variables (types of facts) that are available to the historian and that in the historian's judgment best represent the explored time and place.

These alternatives are not ideal. Law operates in complex social, economic, and intellectual frameworks, which would be very difficult to replicate in an experiment. Experimental validation of a model, therefore, would suffer from being a much-simplified representation of the reality the model attempts to explain.

For the historian, meanwhile, a non-generalizable model, while appealing in the control it gives the historian over the historical narrative, makes this narrative unique and difficult to analogize from, and thus not useful to those interested in other times or places. Furthermore, since such models apply to a single case, they are not testable. Many academic disciplines desire the respectability of the hard sciences, in which the validity of research stems from its replicability. A historian cannot replicate a particular past, but (generalizable) models allow one time and

place to be compared to another, making the historical study a part of a replicated "experiment."

So, if legal history and models are symbiotic, why would their relationship be complicated? Perhaps because they pursue different goals. Historians aim to represent a specific past, and this requires identifying discontinuities from other times and emphasizing the uniqueness of the studied time and place. In contrast, modelers aim to "standardize" multiple times and places and make them comparable, so that they could test the model's success in predicting outcomes.

Some historians entirely reject the portrayal of historical research as an explanation of cause and effect. John Lewis Gaddis, for example, argues that "[r]ecounting the past requires narrative – simulating what happened – but not necessarily modeling. A simulation … attempts to illustrate (not replicate) some specific set of past events … Simulations need not forecast; models must." [Gaddis (2004):65] The reason he believes history must rely on simulation rather than modeling is the large number of interconnected variables that influence an event: "Systems with small numbers of variables … lend themselves to modeling. Systems with many variables don't; the only way you can explain their behavior is to simulate them, which means to trace their history." [Gaddis (2004):80]

Gaddis complains that:

> too many social scientists, in their efforts to specify independent variables, have lost sight of the basic requirement of theory, which is to account for reality. They reduce complexity to simplicity in order to anticipate the future, but in doing so they oversimplify the past. It's hardly surprising that these tendencies have placed the social scientists at odds with historians in general … . [Gaddis (2004):71].

Gaddis's definition of the historical enterprise not only removes the need to forecast, but also the need to address causal relationships. If a model is only applicable to a single case, then causal claims cannot be tested and falsified. The historian's criterion for what facts to include in the narrative is whether the chosen facts best illustrate the events (a subjective, non-falsifiable, judgment).

This fits well with an understanding of history as a representation; a narrative simulating a past reality. If the goal is to simulate the past, objective causation may matter little compared to salience to the reader – as is the case with writing fiction. Generalizable models' focus on abstract variables, which diminishes the importance of characters in the narrative. Characters are tied to a particular place and time, while generalizable models are not, so the model reduces characters to the

circumstances that constrain them. Characters, and the conflicts they face, create a more salient narrative than the abstract, impersonal forces of models. Models get in the way of good storytelling.

But such a view of historical scholarship makes it difficult to distinguish the enterprise of the historian from non-scholarly non-fiction simulations such as journalism. Both create non-falsifiable narratives using falsifiable facts. Individual facts must be objectively true, but no objective standards constrain which facts are recounted and what perceptions the facts are used to evoke. If the story is evocative to its target audience (be it the general public or a specialized group of academic historians), it is successful. Such a goal balkanizes historical scholarship, making the study of each explored space and time less relevant to the study of other places and times, let alone to audiences other than historians.

Or perhaps history as simulation allows any and all analogies. Economist Peter McClelland claims that historians avoid the express assumptions and generalizations that a model requires in order to give the studied events the widest possible appeal, and extend the relevance of their expertise. McClelland cites a telegraph purportedly sent by the Japanese government to historian Charles Beard following the 1923 Tokyo earthquake: "Bring your knowledge of disaster." [Hofstadter (1956):360][2] The historian, says McClelland, "extends to his reader a similar invitation: Come and bring your knowledge, experience, and beliefs, especially your generalizations linking stimuli, dispositions, and human action. I shall supply the facts." [McClelland (1975):87]

I would like to suggest a model explaining scholars' preference for expanding or narrowing the applicability of their research, which focuses on the ability to scale up one's production of scholarship (i.e., to increase the production of scholarship without requiring additional experts, by outsourcing work to non-experts who do not compete for prestige with the scholar).

This model assumes that scholars act to maximize their prestige. A scholar has a choice of narrowing the applicability of her research (by using methods and exploring events that are optimal for the narrow studied area, but are not appealing to or usable by scholars in different

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[2] A historian's knowledge of disaster is still prized, apparently. *The Wall Street Journal* recently reported that hedge funds paid Harvard historian Niall Ferguson "upwards of half a million dollars" for his prediction of the British vote on whether to leave the European Union. [Cui, Hope and Zuckerman (2016)] Mastery of the past did not successfully predict the future in this case: Ferguson wrongly predicted voters would elect to remain in the union.

areas), or broadening it (by employing more generalizable methodologies and considering events that are relevant for those in other areas of study). Broadening applicability would increase the scholarship's value (since it would be valuable to more people), but it would also increase the number of competitors (since scholars in other areas are now part of the competition).

In this competitive environment, one would expect that a scholar would find broadening the applicability of her research more appealing when she can easily scale up her activity to engage a larger audience, and in contrast would prefer to narrow the applicability of her research when she cannot easily scale up her scholarship output. Scaling is easier when the scholar can delegate many tasks to less-experienced assistants and "mass produce" the scholarship.

Pure modelers – who do not conduct empirical study – can scale their output (i.e., apply their ideas to multiple academic markets) relatively easily. Having produced a model once, they need only know enough about a new market to have reason to believe the same dynamics apply there, and to "translate" the model to the new market. Of course, the model must then be tested to be validated, so the modeler needs to either tempt empiricists to test the model (e.g., because the model offers political or personal appeal to empiricists, such as by attracting public or scholarly attention), or engage in the testing herself (threatening scalability, if the testing itself is not scalable).

A scholar who tests a model faces different scaling costs depending on whether the method is quantitative or qualitative. Empirical quantitative analysis tends to be easier to scale than qualitative analysis, as much of the collection and coding of data can often be outsourced to less knowledgeable but more numerous assistants, while the expert-scholar focuses on designing the study and interpreting the findings. The qualitative study of textual or material sources, in contrast, is harder for the expert-scholar to outsource. The equivalent of "coding" – inferring the relevant facts from the text or artifact – requires specialized expertise.

The prediction of this model is that pure modelers, modelers who test their model using quantitative techniques and pure empirical quantitative scholars are more likely to seek to broaden the application of their scholarship, while pure qualitative scholars and modelers who test their model using qualitative methods are more likely to narrow the application of their scholarship. Scholars who are more constrained in expanding their research output, regardless of the demand (and funding) for it, have a lesser incentive to extend their scholarship to other markets. Balkanization is then the prestige-maximizing strategy.

Of course, a scholar's prestige is not the only factor dictating the scholar's academic activity, and scalability is not the only factor affecting prestige. Thus, the model is not true. But is it useful? Only testing can confirm that. Can I tempt you to do the testing?

2. WHAT'S AN EVOLUTIONARY MODEL?

Evolutionary models assume the explored facts (e.g., the contours of the law at a given time and place) are significantly determined by competition between various actors over resources.

An evolutionary model, therefore, needs to determine who the competing *actors* are (i.e., the *unit of selection*). In biological models, some evolutionary models use the individual organism as the unit of selection, while others examine a "micro" unit – the individual gene ([Williams (1966)]). Others still use a "macro" unit – the collective colony, tribe, or group ([Williams (1971); Wilson (1975):106–29]).[3]

Evolutionary models of law typically use the state as the unit of selection. The state is the equivalent of the individual organism (not the collective) in biological models, since it is the state that carries and manipulates the law, not the individual citizens.

In theory, one can imagine an evolutionary model of law that uses a given law itself as the unit of selection. Just as "a hen is only an egg's way of making another egg" [Butler (1878):134], and "the organism is only DNA's way of making more DNA" [Wilson (1975):3], so too perhaps a state is law's way of making more law. Evolutionarily successful laws survive, maintain, and replicate themselves to apply to more events and more persons. Laws, of course, lack the consciousness to intend such behavior, but so do eggs and DNA. Evolutionary models do not need the actors to *intend* to win the competition, or even to be capable of intent. It is enough that certain characteristics an actor possesses cause the actor to win competitions against rival actors, so that actor survives while rival actors do not. I am not aware, however, of any evolutionary model in which the unit of selection is a law.

The legal counterpart of biological models using the collective as the unit of selection would be a jurisdiction of jurisdictions. Such entities exist: sovereign federal governments that consist of sovereign member

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[3] The study of evolution of organizations likewise offers three units of analysis: the individual organization; routines and competencies within an organization (the "micro" unit); and entire organizational populations or communities (the "macro" unit). [Aldrich and Ruef (2006):29–30]

states, and to a lesser extent quasi-sovereign international bodies (e.g., the United Nations) that consist of member states. Yet to my knowledge existing models, to the extent they consider such entities, simply treat them as states, rather than posit a competitive dynamic unique to jurisdictions of jurisdictions. For example, vertical regulatory competition models (which we will discuss later) examine competition between the United States and individual states, rather than with other collectives of states.

A more nuanced treatment of actors distinguishes the "replicator" (which gets selected and retained/inherited) from the "vehicle" or "interactor" that facilitates this process [Hodgson and Knudsen (2004)]. Using this model, the law would be the replicator, and the state or other jurisdiction would be the vehicle/interactor.

An evolutionary model also needs to determine the *resources,* the distribution of which is determined by the competition and the accumulation of which is necessary for the actors' success. The relevant resources are those the access to which is dependent on success in the competition between the actors, and the access or lack of access to which affects either the survival of the actor or its reproduction. If an actor has sufficient access to the resources, the future population of all actors will contain a larger proportion of actors identical to the successful one, and a smaller proportion of actors who failed to sufficiently access their resources.

There is no need that actors all pursue the same resource. Indeed, the greater the difference in the resources pursued by the actors, the less fierce the competition between them and the larger the expected number of surviving actors. [Henderson (1981):14; Henderson (1983):8]

In addition to determining the relevant actors and resources – which Aldrich and Ruef consider together as the *struggle* element of the model [Aldrich and Ruef (2006):25–6] – an evolutionary model needs to contain three other elements: variation, selection, and retention.

Variation is an element of an evolutionary model that explains how actors possess characteristics affecting the competition between actors, which are different from the characteristics possessed by other actors, or by the same actor in the past. Such change (or forming of a new actor with a new characteristic) can be intentional or blind (accidental). [Aldrich and Ruef (2006):17–21] "Variations are the raw materials from which selection processes cull those that are most suitable … The higher the frequency of variations, whatever their source, the greater the opportunities for change" [Aldrich and Ruef (2006):18].

In the context of evolutionary models of law, the characteristic that is varied is the law; typically, a substantive legal rule. The variation

element, therefore, needs to explain how new laws are adopted by a particular actor. In particular, differences in variation between actors affect the frequency of variation: some legal processes lend themselves to more fluctuation in the law than others. A decentralized court system in which differences in applicable law between courts is tolerated (i.e., court splits are not always and immediately resolved) is likely to result in more variation. So do legal rules that give more discretion to the judge in applying them. Centralization of legal education and cultural homogeneity of judges and of lawyers also affects variation, as a more homogenous legal profession is likely to apply the law more uniformly (and thus with less variation).

Finally, the volatility of political conflict over matters addressed by the law likely affects variation. Laws touching on politically contested issues are more likely to vary. In some cases, the volatility of political conflict itself varies in predictable ways that can be modeled. For example, Larry Ribstein pointed out that regulation of corporate and securities laws peaks following stock market crashes and the implosion of stock bubbles, referring to such legal reforms as “bubble laws” [Ribstein (2003)]. During times in which the stock market rises, there is little interest in regulating the market in ways that could threaten the boom. Yet following a stock market bust, political pressure to punish those perceived responsible and to prevent a recurrence of a crash result in rapid adoption of new laws.

So, variation in law is an intentional response to economic conditions, but since law is determined by the occurrence of the economic event and the latter is blind, variation in law is ultimately blind. Romano (2005), however, demonstrates that legal responses to economic events often use the economic event as an opportunity to enact long-sought legal reforms that have little to do with the economic event beyond symbolic similarity. This suggests variance in law is triggered blindly, but its substance is intentional.

The next element of an evolutionary model is *selection*. Selection is an element of an evolutionary model that explains how differences in actor characteristics (that were considered in the variation element) result in the elimination of some actors (or at least significant reduction in the prevalence of such actors in the population). Selection can be external – the elimination of an unfit actor – or internal – the abandonment of an unfit characteristic by the actor [Aldrich and Ruef (2006):17, 21–3].

Not every advantage an actor has leads to survival and not any disadvantage leads to extinction. Evolution is not the survival of the perfect. What makes a particular characteristic (e.g., a law) win the

evolutionary contest is the elimination of actors who have other characteristics. Thus, a selection element of a model needs to show not just that a given characteristic is superior to others, but that actors lacking that characteristic have an increased likelihood of being eliminated.

In the legal context, the selection element is not always easy to specify. The actors are typically states, who will not face external selection (i.e., disappear or become abandoned by their citizens) just because they chose an inefficient legal rule. If a state has some reason to prefer an inefficient corporate law rule, some corporations may reincorporate in other states, but many would remain (e.g., due to inertia or greater access to lawyers familiar with the local law). Internal selection is driven by multiple factors, the dominant of which is competition between politicians over political power in that state. In that competition, the symbolism of a law, the aspects of it that are (and are not) salient, and its perceived distributive effects, may all be more important than the substance of the law or its coherence.

Subjects of a law can "vote with their feet" by migrating to another state if dissatisfied with the law. Usually, however, subject migration is not a significant threat to the state because (as mentioned above) migration costs, inertia, and other considerations limit subjects' ability to migrate in response to unfavorable laws. In the context of corporate law, larger firms can usually justify the costs of migration more easily than smaller firms, and it is these larger firms that are likely to 'forum shop' and migrate out of a state that has an inefficient (or less beneficial) legal rule. Furthermore, many states are not significantly impacted by the migration of those more mobile subjects, because their migration does not threaten the interests of the state's politicians. For example, the threat that firms will reincorporate in another state is likely to affect the political calculus only in states that derive from incorporations a significant portion of the state's income, or of the income of politically powerful factions that lobby the state.

Thus, while our model has so far considered states as the actors in evolutionary competition, the selection element of legal evolutionary models may be determined by competition at a lower level, among political actors within the state. The state is in a sufficiently defensible position that it can survive suboptimal laws that are dictated by internal politics: states with inefficient laws do not disappear from existence, nor are they necessarily deterred from enacting inefficient laws. However, to the extent that our model is concerned with the law that applies to the larger, more mobile subjects (as many corporate law models focus on larger, public corporations), the threat of subject migration will play a role in internal selection in some states (those that derive significant

benefits from the mobile subjects). Other states may have laws selected through different processes that ignore subject migration, but those laws will not affect larger, more mobile subjects (who migrate elsewhere).

The final element of an evolutionary model is *retention*. The retention element explains when variations that are selected are then preserved or reproduced so that the selected characteristics are repeated on future occasions or appear in future generations [Aldrich and Ruef (2006):17, 23–5]. Absent retention, gains from successful variations would quickly dissipate, as the actor or its descendants lose the characteristic, or actors with the characteristic are diluted by new variation [Aldrich and Ruef (2006):23].

In the legal context, retention can occur by a state maintaining a law that has been selected (i.e., proven itself successful), or by other states adopting such selected laws. On its face, the retention element appears easy to establish in the case of legal evolution. Law tends to follow precedent, and laws tend to exist unless replaced, rather than expiring and requiring repeated re-legislation.

But retention requires that those who control the retention or modification of a law are aware of the selection of the particular law and do not gain benefits from adopting another, unselected law.

For example, suppose that a state adopts a corporate law rule that is efficient for biotechnology firms and causes them to flock to incorporate in that state. If the state hardly ever modifies those laws, it would retain this rule. But suppose that following a financial crash, public opinion calls for corporate reform. If the politicians who amend the law are not aware of its popularity with the biotechnology firms, that selection would not affect the politicians' decision to change the law. Furthermore, even if the politicians know that the existing law attracted biotechnology firms, they may find that changing the law to respond to public opinion is more advantageous to them. The same can occur with changes to case law: an efficient precedent can be replaced if the judge is not aware it was efficient, or if the judge views other concerns as outweighing the efficiency.

3. REGULATORY COMPETITION: HORIZONTAL MODEL (STATE VS. STATE)

The most developed family of evolutionary models explaining the development of corporate law is the scholarship on regulatory competition. This family of models shares a common assumption: that corporate law is significantly shaped by competition between legal

jurisdictions (or, in one variation, competition over control of a legal jurisdiction). As we will see, the models differ on the identity of the actors, as well as on the resources over which these actors compete.

Justice Louis Brandeis expressed an early formulation of the regulatory competition model in the 1933 Supreme Court Case *Louis K. Liggett Co v. Lee*:

> Companies were early formed to provide charters for corporations in states where the cost was lowest and the laws least restrictive. The states joined in advertising their wares. The race was not one of diligence but of laxity … [T]he great industrial States yielded in order not to lose wholly the prospect of the revenue and the control incident to domestic incorporation [Brandeis (1933):558–60].

Three key ideas of the regulatory competition scholarship are expressed here. The first, common to several strands of this family of models, is that the relevant actors are states. The second, also shared by multiple strands, is that the resource over which the actors compete is franchise fees and other revenue the state collects from incorporations. The third idea – which is at the core of one strand of this scholarship known as the "race to the bottom" – is that states compete to attract incorporation by lowering the quality of their corporate laws (i.e., not mitigating the agency problem posed by the firm's managers). Implicit in this model is that management decides where firms are incorporated (thus state's efforts are directed to appeal to management), and that management desires high agency costs.

This "race to the bottom" model of corporate law was expressly formulated only 41 years' later, in an article by William Cary [Cary (1974)]. Cary specifically considered the behavior of Delaware, and posited that the attraction of incorporations generates a large amount of revenue for the state government, as well as the state's bar [Cary (1974):668–9]. Cary pointed to examples of Delaware statutory law and case law that he claimed had "watered the rights of shareholders vis-a-vis management down to a thin gruel." [Cary (1974):666], and went as far as claiming that "[p]erhaps there is no public policy left in Delaware corporate law except the objective of raising revenue" [Cary (1974):684].

A competing "race to the top" model was espoused three years later by Ralph Winter. Winter (1977) shared many of the elements of Cary's model, yet reached the opposite conclusion. Like Cary, Winter viewed corporate law as significantly driven by competition between states to attract firms to incorporate in the state. Thus, both models had the same actors and resources. Neither model was too concerned with variation or

retention, most likely because both saw variation and retention as conscious, intentional decisions by states: a state varies the law when it aims to attract more firms, and it retains those laws that proved successful in attracting firms.

The two models differed, however, in their selection element. Cary argued that the incorporation decision is made at the unconstrained discretion of a firm's management, and thus states attract incorporation by lowering management's accountability to shareholders. In contrast, Winter argued that management's discretion is constrained by competition in three spheres: competition for capital (i.e., for shareholders); competition in the product market (i.e., for customers); and competition in the market for corporate control [Winter (1977):256–7].

If managers selected a legal regime that increased agency costs (i.e., managers' freedom to shirk or steal), they would not find shareholders willing to invest in the firm. Shareholders who were already trapped in such firms would be willing to sell their shares at a discount, inviting corporate raiders: entrepreneurs who amass funds to take over a firm, buy it at a discount from disgruntled shareholders, replace the unaccountable management and reincorporate it in a state with efficient laws. Efficient law should increase the value of the firm, allowing the corporate raiders to sell their shares at a premium and earn risk-free profit from their initiative. Facing these threats, Winter maintained, management is deterred from incorporating in a state that has a reputation for lax corporate governance [Winter (1977):263–6].

The difference between Cary and Winter, therefore, lies in their assumptions about the severity of the agency problem between management and shareholders – Winter believes that competition in capital markets, product markets, and markets for corporate control makes the agency problem negligible and therefore makes management pick the legal regime favored by shareholders.

Later scholarship refined the "race to the bottom" model by conceding that the agency problem is greater for certain managerial decisions than others, and thus predicting a "race to the bottom" in some areas of corporate law (such as the implementation of takeover defenses to thwart hostile takeovers, thus suppressing the market for corporate control), while predicting in other areas a "race to the top" that yielded shareholder-friendly law [e.g., Bebchuk (1992):1455–8].

Cary and Winter created two similar models with opposite results, each of which appealed to a large segment of empirical scholars. But both models faced a problem: they were based on the assumption that competition between states over incorporation was the main factor explaining the features of a state's corporate law. Yet evidence of

vigorous interstate competition is limited. Wells (2009) paints a nuanced picture of corporate reform between 1920 and 1940, in which states pursued independent policies, though constrained by the fear of losing incorporations to Delaware.

The most puzzling fact for horizontal models is the paucity of change in the competitive landscape over almost a century. Consider the competitive history in 1933, when Justice Brandeis wrote in *Louis K. Liggett Co v. Lee* the core insights of horizontal regulatory competition: Brandeis described how New Jersey was the first state to modify its corporate law to attract incorporations from other states, how it ceased to do so under Governor Woodrow Wilson, and how Delaware took its place [Brandeis (1933):548–65; Grandy (1989)].When Cary formed the first model of horizontal regulatory competition 41 years' later (1974), the history of state competition he referenced was exactly the same, with the exception that Cary noted that Nevada has been trying (with only modest success) to become the "Delaware of the West."

Fast forward yet another 42 years, to this day, and the competitive history is identical to that presented in Cary's article: Delaware is the dominant state, with Nevada having modest success in attracting a few out-of-state firms. To the author's knowledge, the only development since Cary that appears to be conscious competition with Delaware over incorporations was North Dakota's adoption in 2007 of a corporate law that was decisively anti-management, intended to contrast with and present an alternative to Delaware [Clark and Hough (2008)]. North Dakota's actions did not change patterns of incorporation [Hoffman (2013)].[4]

To sum up, the competitive landscape has not changed since Delaware seized New Jersey's crown in the mid-1910s. It is hard to think of another competitive market that has shown such remarkable stability.

How does one explain Delaware's resilience? The small size of the state's budget gives it greater incentive to attract out-of-state incorporations, since the attracted fees can replace a larger proportion of the state's taxes. Romano (1985) describes it as a form of Oliver Williamson's exchange-supporting hostage [Williamson (1983)]: Delaware relies heavily on franchise taxes and incorporation fees, which it would lose if its corporate law would become less appealing. Loss of this revenue would impose a politically-painful financial burden on Delaware's

[4] Steele (2015):366 remarks: "North Dakota had two publicly traded corporations in 2007 […] And just two remain. So, no vote has yet gained a majority to move from Delaware to North Dakota in order to take advantage of [North Dakota's law]."

citizens, so corporate stakeholders can be assured that Delaware's politicians would strive to maintain Delaware's appeal. States with more revenue cannot make an equally credible commitment, since compensating for the loss of incorporation-related revenue would be less politically painful for them.

In fiscal year 2013, Delaware's revenue from corporate franchise taxes was $776.7 million, and its revenue from abandoned property (also connected to attracting incorporations, because much of it relates to unclaimed assets in the possession of Delaware firms) was $566.5 million [Starkey (2014)]. But Delaware is not the only state with a small budget. In fiscal year 2014, Delaware's total state revenue was about $9.3 billion; more than South Dakota ($6.1), Vermont ($6.5), Wyoming ($7.5), New Hampshire ($8.3), Montana ($8.9), and Rhode Island ($9 billion) [U.S. Census Bureau (2014)]. An annual infusion of over $1.3 billion would dramatically ease the burden on their taxpayers. So, why not New Hampshire?

Some degree of "first mover advantage" may be explained by the fact that Delaware is fighting to keep revenue it already has, while other states face only the speculative prospect of gaining new revenues. But this argument does not go very far. Losing existing revenue may be politically more painful than foregoing gaining the same revenue, but over time most states face revenue shocks that would likely make them as desperate to attract new revenue as Delaware is to avoid losing its existing revenue.

Macey and Miller (1987) augment the "small state" quantitative argument by emphasizing a qualitative aspect: few large corporations are physically present in Delaware, so its government does not face strong political pressures from "unions, environmental groups, local communities, or other special interests associated with the corporation's physical plant or assets" [Macey and Miller (1987):490]. But this, too, does not appear to distinguish Delaware from several other small states.

Some scholars suggested that Delaware's resilience can be explained by strong network effects that protect a large incumbent from more efficient, but smaller entrants. Network effects are the phenomenon that the benefit to a user of a "network good" increases (either through increased value of the good or through lower cost of it) as other people use the network good as well. Such effects exist, and give a competitive advantage to, the largest incumbent: in the law itself (greater use of the law leads to more precedents and thus less uncertainty), in legal practice (greater use of the law leads to developing more efficient and varied processes and norms), and in supporting services (economies of scale

lower costs of services needed to implement corporate law, such as lawyers, service companies, consultants, etc.) [Klausner (1995)].

But how much inertia can network effects explain? Network effects exist in many markets, yet few, if any, markets have remained with the exact same competitive landscape for a century. This, despite great changes in states' fortunes and opportunities.

Horizontal models such as Cary's and Winter's, therefore, are challenged in their core premise: that states compete over attracting incorporations by modifying corporate law [Kahan and Kamar (2002)].

4. REGULATORY COMPETITION: VERTICAL MODEL (STATE VS. FEDERAL)

Vertical models assume that Delaware corporate law is significantly shaped by competition with federal securities laws, rather than with other states [Roe (2003)].[5] Through regulation of securities and securities exchanges, the federal government shapes corporate law. Unlike the static balance between states in the market for incorporations, the balance between state corporate law and internal governance mandated directly or indirectly by federal securities law has been dynamic in recent decades, with an increasing federal role applying rules that constrain management [Bebchuk and Hamdani (2006)].

The ferocity of competition depends on the degree to which competitors aim for the same resources [Henderson (1981):14; Henderson (1983):8]. Therefore, one may expect less rivalry in vertical models than in horizontal ones, since states aim to capture franchise fees (so one state's gain is other states' loss), while the federal government has other goals (such as addressing or appearing to address a concern voters have with corporate conduct). If indeed corporate law is shaped by competition between the federal and state government, one may expect them to reach an accommodation that would give the state its desired incorporation revenue at the same time it accommodates the federal government's goals (e.g., ensure the state does not "steal the federal government's thunder" by appearing to solve corporate misconduct problems or by standing in the way of the federal government's solutions).

But why would the federal government bother to accommodate the state at all? Federal law can overrule and preempt conflicting state

[5] I am not aware of scholarship considering vertical competition between the federal government and a state other than Delaware.

legislation as long as it follows constitutionally appropriate methods (such as directing exchanges, over which the federal government has authority, to enforce a rule, rather than directly enforcing the rule against corporations).

In an unpublished article, Brett McDonnell offers an innovative argument for how such competition could exist [McDonnell (2004):9–13]. As McDonnell explains, Delaware cannot overcome federal law, but it can preempt its creation. It can do so by positioning Delaware law in a way that thwarts cooperation between segments of the federal government that must cooperate to act for the federal government.

Here is a (slightly abstract) illustration, using McDonnell's model to explain Delaware law regarding proxy access (the right of shareholders to place their preferred directorship candidates on the board's proxy card, which makes a proxy contest against the board much cheaper for shareholders). Suppose that the approaches the law can have toward proxy access are placed on a spectrum, with 10 being the most accommodating rule (e.g., any shareholder has the right to place their candidates on the board's proxy card) and 0 being the least accommodating rule (e.g., board cannot be required to allow shareholders access to its proxy). Suppose also that Delaware law currently rates on this spectrum as 2, the U.S. Senate's preferred position is 5, and the U.S. House of Representatives' preferred position is 9. Under these circumstances, the Senate and House can compromise on federal law mandating proxy access rating 7 on our spectrum (averaging the Senate and House preferred positions).

However, Delaware can preempt that by changing its law so that it now rates as 4. Now, the Senate needs to choose between cooperating with the House, resulting in federal law that rates 7, or not cooperating, maintaining Delaware law's position at 4. Because 4 is closer than 7 to the Senate's preferred position of 5, the Senate will not join the House to enact federal law. Thus, according to this model, vertical competition caused a change in Delaware corporate law from position 2 to position 4, even though no federal law was in fact enacted.[6]

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[6] This model does not explain why the House would not counter Delaware (e.g., by offering the Senate compromise legislation that rates 5.9). It is possible, though, that the House would be more reluctant to compromise. Delaware's actions, in the politically non-salient form of technical legislation or court decisions, would be driven by pragmatic considerations. In contrast, politicians in Congress would be reluctant to be seen enacting compromise legislation, for fear that voters would see them as "selling out" (an incentive discussed in Gilmour (1995)).

Roe (2005) suggests a different mechanism for Delaware to preempt federal encroachment. In Roe's model, the impetus for federal action is driven not by the preferences of federal actors, but indirectly through pressure on those federal actors by two groups of stakeholders: shareholders and managers. Delaware preempts competition by mediating between the stakeholders and offering the parties a fair compromise that each party prefers over federal intervention (which in the short run might give a stakeholder more of their desired rules, but in the long run may result in directing future conflicts with the other stakeholder to a forum that is less committed to balance because it cannot be preempted). In other words, the threat Delaware faces of federalizing an issue if a major stakeholders is very dissatisfied is what makes Delaware able to credibly commit to fairness in a way the federal government cannot.

Vertical models do not explain the "why not New Hampshire?" question – that is, why Delaware dominates out-of-state incorporations. Roe (2003) simply states that "Delaware has 'won' that race." Vertical models rely on the literature on network effects we discussed above to cause sufficient "stickiness" that competitive threats from other states are not sufficient to drive changes in corporate law. Rather, it is attempted preemption of federal encroachment that is the main driver of change, according to vertical models.

What evidence do we have of the federal government shaping Delaware corporate law? Elson and Gyves (2004) points to an example of federal law shaping Delaware law: in 1991 the Federal Organizational Sentencing Guidelines were released. These guidelines offered mitigating factors that could significantly reduce an organization's criminal sentence for violating federal law, including the existence of "an effective program to prevent and detect violations of law … by its employees and agents" [Elson and Gyves (2004):697–8]. Then-prevailing Delaware law, governed by the 1963 case *Graham v. Allis-Chalmers Manufacturing Co*, did not impose a duty on a board to enact a compliance program in the absence of warning signs of illegal conduct. The Sentencing Guidelines created an incentive for Delaware corporations to follow federal standards of corporate governance that contrasted Delaware ones. According to Elson and Gyves, this threatened Delaware and prompted it to protect its franchise by ruling, in the 1996 Chancery case *In Re Caremark International Derivative Litigation*, that boards have an affirmative duty to create some kind of monitoring and compliance mechanism. [Elson and Gyves (2004):698–9]

Viewing *Caremark* as the outcome of vertical regulatory competition and interpreting it through the lens of McDonnell (2004), Delaware was acting to preempt federal courts from acting to fill with content the

general prescription made by the U.S. Sentencing Commission. If Delaware's corporate governance requirements moved sufficiently close to the views of federal judges applying the sentences, they would perhaps import the Delaware standards as the ones qualifying for a sentence reduction, rather than inventing federal standards that would be in line with the Sentencing Commission's views.

Yet this example illustrates the limits of the vertical model of regulatory competition. If it was a response to federal encroachment, it came five years after the event that supposedly triggered it, came from an important but junior Delaware actor (the Court of Chancery, rather than the legislature or the Delaware Supreme Court), and later interpretations of *Caremark* (*Stone v. Ritter* and its progeny) appear to gently roll back the ability to succeed in a *Caremark* suit, even as federal prosecution of corporations has increased since 1996.

Recent federal priorities appear to be regulating risk management and encouraging specialized compliance functions within firms' management [Griffith (2016)]. The Delaware law counterpart to these is the above-mentioned *Caremark* line of cases. This aspect of Delaware law has not fluctuated much since *Stone v. Ritter*. If any trend can be traced in this area, it is an increased difficulty of proving *Caremark* liability, which places bad faith liability for board inactions, in the absence of evidence of self-dealing, on an equal footing to a corporate waste challenge to board actions. This modification appears aimed more at Delaware law's internal coherence than at preempting or responding to the federal government.

Meanwhile, Delaware modifies its corporate statute annually and its case law even more frequently. Yet the majority of these amendments appear to have little to do with issues that concern the federal government. Therefore, while some changes to corporate law may be the product of state preemption or response to federal action, this model does not appear to explain most changes to corporate law.

5. REGULATORY COMPETITION: INTRASTATE MODEL (INTEREST GROUP VS. INTEREST GROUP)

The vertical model in Roe (2005) considered two interest groups (shareholders and managers) as important actors in the competitive process, because the lobbying of either of them was seen as the likely impetus for federal action in corporate law. In Roe's model, Delaware was seen as an autonomous actor attempting to please these interest groups sufficiently to preempt either's call for federal action.

Macey and Miller (1987) proposed an alternative model in which the competition that shaped Delaware corporate law was not primarily between Delaware and other states or the federal government, but within Delaware, among interest groups jockeying for influence over Delaware's actions.

In this model, all relevant interest groups share the goal of maintaining Delaware's dominance in order to increase the revenue flowing to Delaware from out-of-state incorporations. They differ, however, in how to allocate this revenue, with one coalition (of state-supported entities) seeking to increase direct revenue (e.g., incorporation fees), while another coalition (dominated by the Delaware bar) seeks to increase indirect revenue (e.g., lawyers' and consultants' fees) [Macey and Miller (1987):502–5].

The model predicts an advantage to the indirect revenue coalition, because of the influence of Delaware's bar on its judiciary [Macey and Miller (1987):500–502], the cohesion of Delaware's bar, and the lack of cohesion in the direct revenue faction (where constituent interest groups are also rivals competing over the allocation of state revenue) [Macey and Miller (1987):507–8]. Support for this prediction may be found in a recent empirical study of merger litigation [Cain and Davidoff (2015)], which presented evidence of interstate competition to attract litigation (an indirect source of incorporation revenue). While the findings were framed in terms of horizontal regulatory competition, the observed outcome of this competition suggests that the dominant motivation for regulatory competition may come from the bar rather than the treasury.

6. REVISED INTRASTATE MODEL: EXPLAINING DELAWARE'S RESILIENCE

Intrastate models are premised on competition between interest groups over a particular resource: benefits from out-of-state incorporations. The paucity of interstate competition suggests that this resource is not so attractive, limiting the significance of competition over it. Thus, like horizontal models, intrastate models also need an answer to "why not New Hampshire?"

And I believe an intrastate model provides an answer. In all states, the general public tends to have negative views of corporate conduct, and is unsympathetic to managers and sometimes also to shareholders and operational efficiency (in comparison with employees, the environment, diversity, etc.). Therefore, there is significant populist pressure on politicians and judges (who may also share these views), in particular during

economic downturns. Most states cannot credibly assure firms that at times of populist surges the law would not become hostile to their interests.

But as Macey and Miller (1987) argued, Delaware's past dominance has created powerful interest groups that depend on demand for Delaware corporate law. These interest groups – primarily the defense bar and plaintiff's bar, but also specialized consultants, and litigation and incorporation support services[7] – would lose much if firms reincorporated elsewhere or stopped litigating in Delaware. Therefore, they spend significant resources to influence Delaware law and ensure that Delaware remains dominant. Like any interest group, they aim to maximize their interests, but these interests are constrained by Delaware's competitive position. Most importantly, because reincorporation is easy, they must satisfice the interests of shareholders and managers, protecting them up to the point that reincorporation is not desirable. Beyond that, the interest groups maximize their interests, though this too requires compromise since different interest groups in the coalition have opposing interests (e.g., pro-plaintiff vs. pro-defense: maximizing incorporations vs. maximizing litigation).

Delaware's existing interest groups (both pro-shareholder and pro-management) would lose much from a turn to populism that would drive away firms, and their political power assures firms that Delaware would not pursue a populist agenda in its corporate law.

Other states cannot instantly manufacture a politically powerful anti-populist coalition in the way they can instantly overcome other Delaware advantages. Other network effects can be replicated quickly if enough funds were directed to that goal: laws can be copied, legal expertise and support services nurtured, and revenue deficits covered by borrowing. But money alone cannot quickly establish an interest group that does not yet exist.[8] New Hampshire's corporate lawyers may hope to profit from

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[7] Unlike Roe (2005), I do not think the primary interest groups are the firm's stakeholders. This is because firms can exit Delaware easily and reincorporate elsewhere, so (following Hirschmann (1970)) they do not need to spend many resources on "voice" (influencing Delaware actors). Stakeholders are important, indirectly, because the interest groups use their influence to fashion corporate law in a way that maximizes their interests, subject to satisficing the interests of firm stakeholders sufficiently that their firm does not reincorporate elsewhere.

[8] The difficulty is not just in forming a coalition, but in first "manufacturing" the interests of the coalition's constituents, that is creating incentives that do not currently exist, that would lead individuals and firms to want to form the interest group.

becoming the new Delaware, but since none of them is assured that they (and not other lawyers) would be the ones capturing the profits, they cannot justify the costs of acquiring sufficient political power to prevent their politicians from accommodating populist public sentiment. Also, it is not clear what would be the balance of power between different members of the coalition when New Hampshire supersedes Delaware. It is therefore difficult to negotiate terms acceptable to all coalition members.

This model differs from Macey and Miller (1987) in that the latter considered competition between interest groups fighting over incorporation-related revenue. These do not distinguish Delaware from other states, except that the intensity of the competition would be greater in Delaware, corresponding to the larger revenue. In contrast, my model considered a populist faction (in the sense of supporting redistribution from management and shareholders to others outside the firm), which is present in all states, but which can only be countered in Delaware, because of the difficulty in manufacturing a pro-firm interest group in other constituencies, even if they are similarly small states with few resident large firms.

The intrastate model is constrained by the populist faction's influence over the federal government. There are certainly pro-firm interest groups actively lobbying the federal government, but they are not as strong as their Delaware counterparts. Thus, vertical models are likely to have stronger explanatory powers regarding corporate reforms that address populist preferences. In contrast, intrastate models better explain the remainder of changes in corporate law, which maximize the interests of the Delaware interest groups, subject to first satisficing the interests of incorporation "customers" (management and shareholders) so that they do find the law so unappealing that they forego the political protection of the pro-firm interest groups and migrate out of Delaware.

Is this political protection normatively desirable? In other words, does the power of a pro-firm political faction, at the expense of a populist faction, enhance the welfare of all citizens? Arguably, yes.

When each voter has a negligible impact on the outcome, voters rationally vote symbolically rather than pragmatically, supporting un-obtainable "first-best" agendas over obtainable "second-best" ones. When a voter's vote is unlikely to change the outcome of the election, the vote is most valuable as a form of consumption – expressing their preferences by supporting politicians who stand for their "first-best" preferences.[9]

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[9] In contrast, when an individual's vote has significant influence on the outcome, the individual is more likely to forego the expressive benefit of

The alternative, voting for a pragmatic politician who offers an obtainable "second-best" agenda, would not get that politician elected, since the individual voter's vote has no impact. But it would take away the pleasure of expressing one's beliefs.

Populist agendas (as opposed to agendas of politically cohesive non-firm stakeholders, such as labor unions) aim at large number of voters, each of whom has little influence on the vote outcome. They tend to be symbolic, aimed at appearing adversary to the interests of firms, management, and (sometimes) shareholders.

It would be rational for a non-firm stakeholder to vote for an uncompromising anti-firm agenda rather than for a compromise that would accommodate enough of the firm's interests to keep the firm from reincorporating elsewhere or reducing its activities. The uncompromising agenda is more emotionally satisfying, and it does not affect the likelihood of a compromise outcome since the individual vote has no significant effect on outcomes. Yet overall the result may be a victory for politicians who stick to ideal preferences because voters would punish them for compromising (viewing the politician as "selling out"), but excuse them and blame ideological rivals for stalemate or failure [Gilmour (1995)].

The existence of a dominant pro-firm interest group in Delaware may serve as a check on the threat of symbolic anti-firm legislation, and assure firms that Delaware law would not be used as a vehicle for symbolic political action. Other states cannot replicate the political power of this anti-populist interest group, explaining Delaware's resilience. Meanwhile, the threat of federal intervention may serve as a "check on the check," constraining firms' aspirations and giving Delaware's corporate law industry more leeway to pursue its own revenue-maximizing interests. Thus, the vertical and intrastate models may support each other.

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